



Australian Government

The Board of Taxation

REVIEW OF CORPORATE TAX RESIDENCY

the **board** of **taxation**
www.taxboard.gov.au

A Report to the Treasurer

JULY 2020

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer following its review of Australia's corporate tax residency rules.

The Board's review involved assessing the current corporate tax residency rules and considering whether the existing rules are operating appropriately in light of modern, international and commercial board practices and international tax integrity rules.

The Board appointed a Working Group that included Board members Mr Neville Mitchell, Dr Julianne Jaques, Mrs Ann-Maree Wolff and Mr Chris Vanderkley. The review was led by Mr Neville Mitchell.

Over 40 participants attended our roundtable consultations in Melbourne, Sydney and Perth. In addition, the Board received numerous written submissions and collected further feedback from private interviews with stakeholders. The Board would like to thank all those who contributed to our consultation process. We also thank the Australian Taxation Office and the Treasury for their assistance to this review.

The ex-officio members of the Board — the Secretary to the Treasury, Dr Steven Kennedy PSM, the Commissioner of Taxation, Mr Chris Jordan AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the observations and recommendations made in this report for advice to Government.



Rosheen Garnon
Chair of the Board



Neville Mitchell
Chair of the Working Group

EXECUTIVE SUMMARY

One of the cornerstones of Australia's tax system is the concept of corporate 'residency'. Introduced over 90 years ago, it remains key in determining Australia's taxing rights over profits earned by companies in Australia, as well as foreign companies doing business here.

The Government asked the Board to review this fundamental aspect of the tax system to ensure it was operating appropriately in light of significant changes in the way modern companies now do business. These changes have accelerated in the last two decades, including as a consequence of the increasing globalisation of the economy and labour, the evolution of corporate governance practices and significant advancements in modern technology.

Following the High Court's decision in the *Bywater*¹ case the ATO has changed its administrative guidance. This has fundamentally altered long established practice, with the business community now raising strong concerns around distortions and excessive red tape.

The Board has found the rules as they currently apply to foreign incorporated companies are in need of reform. They are out of step with modern business practices, create considerable uncertainty, are susceptible to manipulation and increase the potential for international disputes. As a consequence, many corporates are experiencing a significant increase in financial costs and disruptions to business.

Whilst finalising this report, the need for reform became axiomatic as the Coronavirus pandemic radically restricted international travel. COVID-19 has highlighted practical issues with an approach that has become heavily weighted to whether directors physically fly to board meetings and reinforces that the current rules are no longer fit for purpose.

In accordance with the Government's terms of reference, the Board has developed a model to reform the corporate residency rules as they apply to foreign incorporated companies. This model has been designed to enhance the veracity of the rules for modern corporates, provide greater certainty, remove unnecessary red tape and make it easier for businesses to operate.

The Board's recommendations reinforce the integrity of the tax system (recognising how fundamental the concept of corporate tax residency is in the Australian tax system) and minimise the risk of companies inadvertently 'flipping in and out' of residency given the material financial consequences that this can trigger.

¹ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45 ('Bywater')

The Board's proposed rules

It is the view of the Board that there must be a sufficient economic connection between Australia and a company that has been incorporated overseas for that company to be considered an Australian tax resident. A sufficient economic connection will exist for these purposes where both the company conducts its core commercial activities in Australia and has its central management and control in Australia.

Requiring this economic connection to Australia acknowledges the real consequences of tax residency - Australia becomes able to tax a foreign company's income no matter where earned in the world (as opposed to only its income earned from Australia).

Incorporating this concept will also address the lack of alignment between the current administrative guidance, which focuses heavily on the physical location of directors for board meetings, and the reality of modern day business. It will provide more consistent and stable tax outcomes. To provide sufficient certainty to both business and the tax administration, an overarching framework on the circumstances under which core commercial activities can be said to be conducted in Australia should be reflected in the law.

This overarching framework should be supplemented with practical guidance provided by the ATO that can be updated in real time in line with evolving business practices. Similarly, the ATO could look for opportunities to modernise its existing practical guidance on central management and control to reflect the impact of technology and globalisation on corporate board practices.

The Board notes that many stakeholders submitted that company residency should be exclusively based on a place of incorporation. Whilst, this approach would provide certainty and reduce the compliance burden, ultimately the Board was concerned with the prospect this approach could create integrity risks. Additionally, given Australia's high corporate tax rate relative to other countries, an incorporation only test would incentivise companies to incorporate overseas.

Lastly, the Board notes that the current corporate residency rules contain a test that looks to the voting power over a foreign company. Many stakeholders questioned whether it added any value and called for its removal. Whilst the Board could not find any evidence of this rule being applied in practice, it has not recommended its removal at this time. This is on the basis that a review of the effect of removal, including any unintended consequences for the system more broadly, has not been undertaken. The Board considers that this should be considered as part of its recommended Government post implementation review of any changes made to the corporate residency rules.

The road to reform

The proposed rules minimise commercial uncertainty and ambiguity, create better alignment with modern day corporate and board practices whilst supporting the integrity of Australia's tax

system. The impact of this reform will be to remove unnecessary red tape and compliance costs, making it easier for businesses to operate.

In developing its proposals, the Board consulted extensively across large and small business, academia, professional bodies and taxation advisers. The Board received numerous written submissions and held roundtable consultations across the country. The Board acknowledges and thanks all participants in its consultation process. The feedback that the Board consistently received reinforced the urgent need for reform.

The Board worked closely with the Treasury and the ATO, and consulted with the Office of Parliamentary Counsel in formulating its recommendations to ensure that, to the extent possible the proposed rules reflect a consensus-based approach that will operate appropriately in light of modern, international commercial board practices and international tax integrity rules.

Given the significant uncertainty and substantial unnecessary compliance cost currently being borne by companies, and the urgency expressed by all consultees, the Board is of the view that there is a strong case for prioritising this reform and that the matter should be dealt with expeditiously.

LIST OF RECOMMENDATIONS

RECOMMENDATION 1

The 'central management and control test' should be modified to ensure that for a foreign incorporated company to be an Australian tax resident there needs to be a sufficient economic connection to Australia.

Sufficient economic connection to Australia will be best demonstrated where together both the company's core commercial activities are being undertaken in Australia and its central management and control is in Australia. Central management and control in Australia, by itself, will not be sufficient except in very limited circumstances (such as with certain holding companies).

The new rules should apply prospectively and as soon as possible after receiving Royal Assent, but a foreign incorporated company should also have the option to choose for the rules to take effect from the date TR 2004/15 was withdrawn (15 March 2017).

The new rules should be subject to a Government review three years after receiving Royal Assent.

RECOMMENDATION 2

Overarching guidance of the circumstances under which the core commercial activities of a company can be said to be conducted in Australia should be provided in the legislation and extrinsic materials.

This should be supplemented with administrative practical guidance that includes the treatment of 'holding companies' and the need for a *de minimis* threshold.

RECOMMENDATION 3

The ATO should consider providing additional practical guidance on the meaning of the term 'central management and control in Australia' to provide greater alignment with modern business practices.

RECOMMENDATION 4

The 'voting power test' should be retained at this time.

Any change from the wording "carries on business" to referencing core commercial activities in the 'central management and control test' should likewise be applied to the 'voting power test'.

RECOMMENDATION 5

The Board recommends that basing residency solely on a place of incorporation test should not be adopted.

RECOMMENDATION 6

The Board does not recommend adopting a corporate residency test based on place of management or place of effective management.

GLOSSARY

The following abbreviations and acronyms are used throughout this report.

Abbreviation	Definition
ATO	Australian Taxation Office
Board	Board of Taxation
PCG 2018/9	Practical Compliance Guideline PCG 2018/9 <i>Central management and control test of residency: identifying where a company's central management and control is located</i>
Reform option 1	Modify the central management and control test to ensure the test is applied in two steps, consistent with the application under the former ruling TR 2004/15
Reform option 2	The residence of a company would be determined solely by the place of its incorporation
TR 2004/15	Taxation Ruling TR 2004/15 <i>Income Tax: residence of companies not incorporated in Australia – carrying on business and central management and control</i>
TR 2018/5	Taxation Ruling TR 2018/5 <i>Income tax: central management and control test of residency</i>
Two limbed test	In order to be a resident a company <i>must carry on business in Australia and have its central management and control in Australia.</i>

CHAPTER 1: INTRODUCTION

- 1.1 On 5 August 2019, the Treasurer requested that the Board of Taxation (the Board) conduct a review (the review) of the operation of Australia's corporate tax residency rules.

Terms of reference

- 1.2 The Terms of Reference provided by the Treasurer are:

The purpose of the review is to ensure the corporate tax residency rules are operating appropriately in light of modern, international, commercial board practices and international tax integrity rules.

In particular, the Board is asked to consider whether the existing rules:

1. minimise commercial uncertainty and ambiguity;
2. are consistent with and aligned with modern day corporate board practices;
3. protect the tax system against multinational profit shifting; and
4. otherwise support Australia's tax integrity rules as they apply to multinational corporations.

The review team

- 1.3 The Board appointed a Working Group led by Board member Mr Neville Mitchell (Chair of the Working Group), with assistance from Board members Dr Julianne Jaques, Mrs Ann-Maree Wolff and Mr Chris Vanderkley. In addition, the Working Group comprised members of the Board's Advisory Panel and private sector experts, namely Mr Michael Crocker (CA ANZ), Mr Paul Hooper (Lendlease), Mr Theo Sakell (Pitcher Partners) and Prof. Richard Vann (University of Sydney), as well as officials from the Department of the Treasury and the ATO.

Consultation process

- 1.4 The Board's consultation process has involved:
- The publication of a Consultation Guide (in September 2019) describing the scope of the review, and presenting a series of questions to identify the key difficulties being encountered and possible reform options.

- Face-to-face consultations with over 40 participants across a series of roundtables conducted in Melbourne, Perth and Sydney.
- The publication of a Reform Options Paper to canvass feedback on two reform options that emerged from the Consultation Guide and roundtable discussions.

Submissions

- 1.5 The Board received 25 written submissions, including seven confidential submissions, from a range of stakeholders to the two consultation papers (the Consultation Guide and the Reform Options Paper). It was noted that the Tax Institute's submission included the results of a survey of its members.
- 1.6 The Board recognises the significant contributions made by stakeholders in making their submissions. The Board carefully considered all submissions and other contributions made during the process. Further details of the consultation process and submissions are available at Appendix A.

The Board's report

- 1.7 In formulating this report the Board has considered every issue raised by consultees in submissions and at the roundtable consultation meetings, and the views of the members of the expert panel. The Board's recommendations were developed specifically in response to the terms of reference, utilising the principle of 'sufficient economic connection with Australia' as a benchmark to confer tax residence and with reference to the following considerations:
 - ensuring that a company's residency status is 'sticky', such that residency is not volatile and subject to short term changes;
 - enhancing the veracity of the rules to ensure that a company's residency status is not determined solely or predominantly on the basis of board meetings being attended in person, as opposed to meetings being attended via internet based conferencing platforms;
 - accommodating developments in modern corporate governance;
 - encouraging Australian business growth, including through removing unnecessary red tape and making it easier for businesses to operate;
 - minimising the transitional and unintended tax impacts arising from any change in Australia's corporate tax residency settings;

- lowering integrity risks brought to the Board's attention that arise from the potential for the current central management and control test to be manipulated; and
- removing unnecessary compliance costs and business inefficiencies in managing Australian tax matters.

CHAPTER 2: AN OVERVIEW OF AUSTRALIA'S CORPORATE RESIDENCY RULES AND THEIR ADMINISTRATION

KEY POINTS

- Australia employs a residence based approach to determine the territorial reach of its income tax legislation. Broadly, an Australian resident company is liable to tax on its worldwide income whereas a non-resident company is only liable to tax on its Australian sourced income.
- The focus of the Board's review has been on the operation of the central management and control test in the company residence rules. This test treats a foreign incorporated company as an Australian tax resident where it is both carrying on business in Australia and has its central management and control located in Australia.

- 2.1 Australia's tax settings centre around two concepts: the residence of a taxpayer and the source of income. The concept of residence is essential in determining the scope of Australia's taxing rights. Residents of Australia, in general, are taxed on their worldwide income (Australian sourced income and foreign income). In contrast, non-residents are only taxed on Australian sourced income. In Australia the residence of a company is also important to a number of tax settings, such as dividend imputation and tax consolidations.
- 2.2 In accordance with international taxation norms the residence of a company is ordinarily determined under two broad methods, a form based test of where the company is created (the place of incorporation) and a substance based test to determine where the *'real seat'* is located.

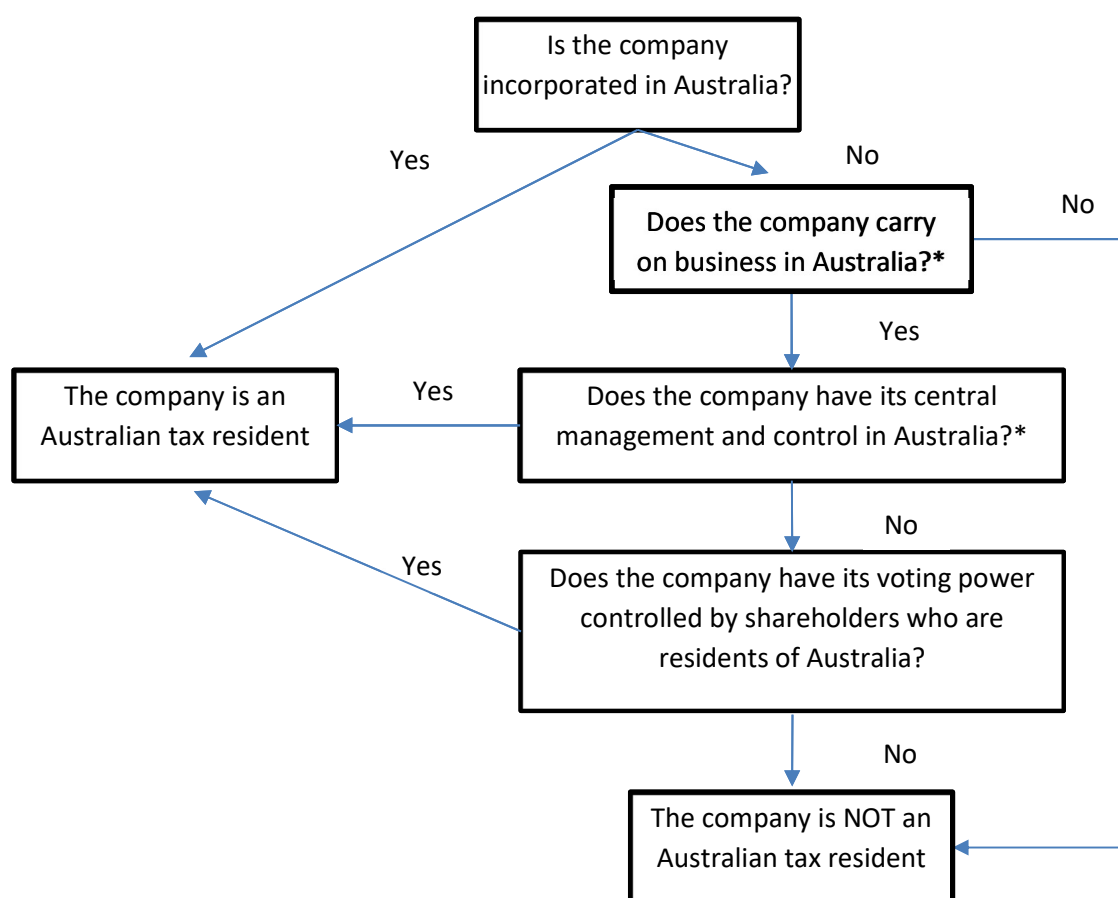
Australia's company residence rules

- 2.3 Australia's tax laws, along with many other countries (such as Canada and the United Kingdom), use a combination of both methods described in paragraph 2.2 to determine if a company is an Australian tax resident. In Australia these two methods are supplemented with a voting power test. As such there are currently three alternative tests for company residence within Australia's tax laws.² A company will be an Australian tax resident if it satisfies any of the following:

² Income Tax Assessment Act 1936 (Cth) subsection 6(1).

- The company is incorporated in Australia (**place of incorporation test**).
- The company 'carries on business' in Australia **and, has either**:
 - Its 'central management and control' in Australia (**central management and control test**); or
 - Its 'voting power' controlled by shareholders who are residents of Australia (**voting power test**).

2.4 The current framing of the company residence rules is illustrated by the decision tree below:



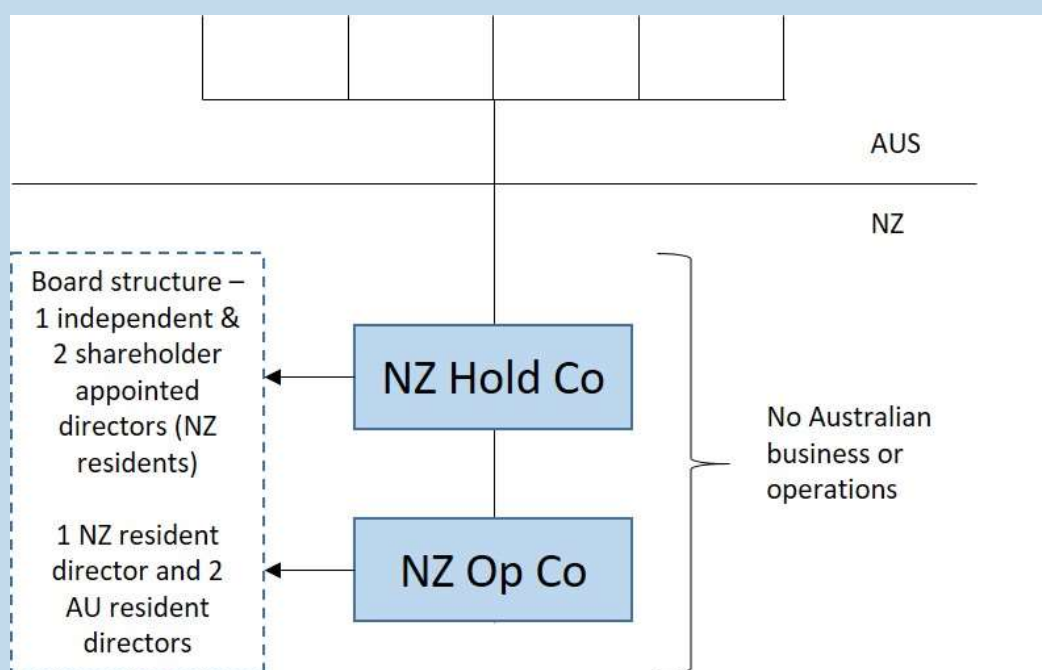
* In some circumstances, the exercise of central management and control would also constitute carrying on of business.

2.5 The practical application of the company residence rules and the decision tree is demonstrated in the following example:

Example 1– NZ based manufacturing operations

NZ Op Co is a company incorporated in New Zealand that owns manufacturing assets situated in New Zealand. It has no business interests outside of New Zealand. NZ Op Co is wholly owned by NZ Hold Co which is also incorporated in New Zealand. NZ Hold Co is owned by a number of Australian residents. NZ Hold Co has no physical assets in New Zealand, and no business interests or assets outside New Zealand.

The day-to-day management and operation of both companies is undertaken from the corporate office in New Zealand by a New Zealand resident management team. NZ Hold Co has three New Zealand resident directors (one independent and two shareholder appointed). NZ Op Co has one New Zealand resident director and two Australian resident directors. This is summarised in the diagram below:



Guided by information provided by the New Zealand based management team, the directors meet monthly to make governance and strategic decisions. These meetings are generally physically located in New Zealand. However, to reduce time and costs the Australian resident directors may attend board meetings via video conference or telephone conference on occasion.

Applying the company residence rules to NZ Op Co and NZ Hold Co

NZ Op Co and NZ Hold Co do not satisfy the place of incorporation test as they were incorporated in New Zealand.

Under ATO administrative guidance, TR 2004/15, NZ Op Co and NZ Hold Co do not satisfy the requirements of the other two residence tests as both companies are not carrying on

business in Australia. All the business assets and operations generating the profits are located outside of Australia.

- 2.6 The Board's review determined that the first test is working appropriately. Feedback from consultees indicated, however, that the recent High Court decision in *Bywater* has prompted the ATO to update its administrative guidance in recognition of certain *obiter dicta* provided by the court.³ This has directly impacted on the manner in which the second alternative test for residency is now administered.⁴
- 2.7 Accordingly, the focus of the Board's review has been on the second alternative test for residence. That is, to be a resident a company *must carry on business in Australia and have its central management and control in Australia*. This is referred to in this report collectively as the central management and control test (the two limbed test).

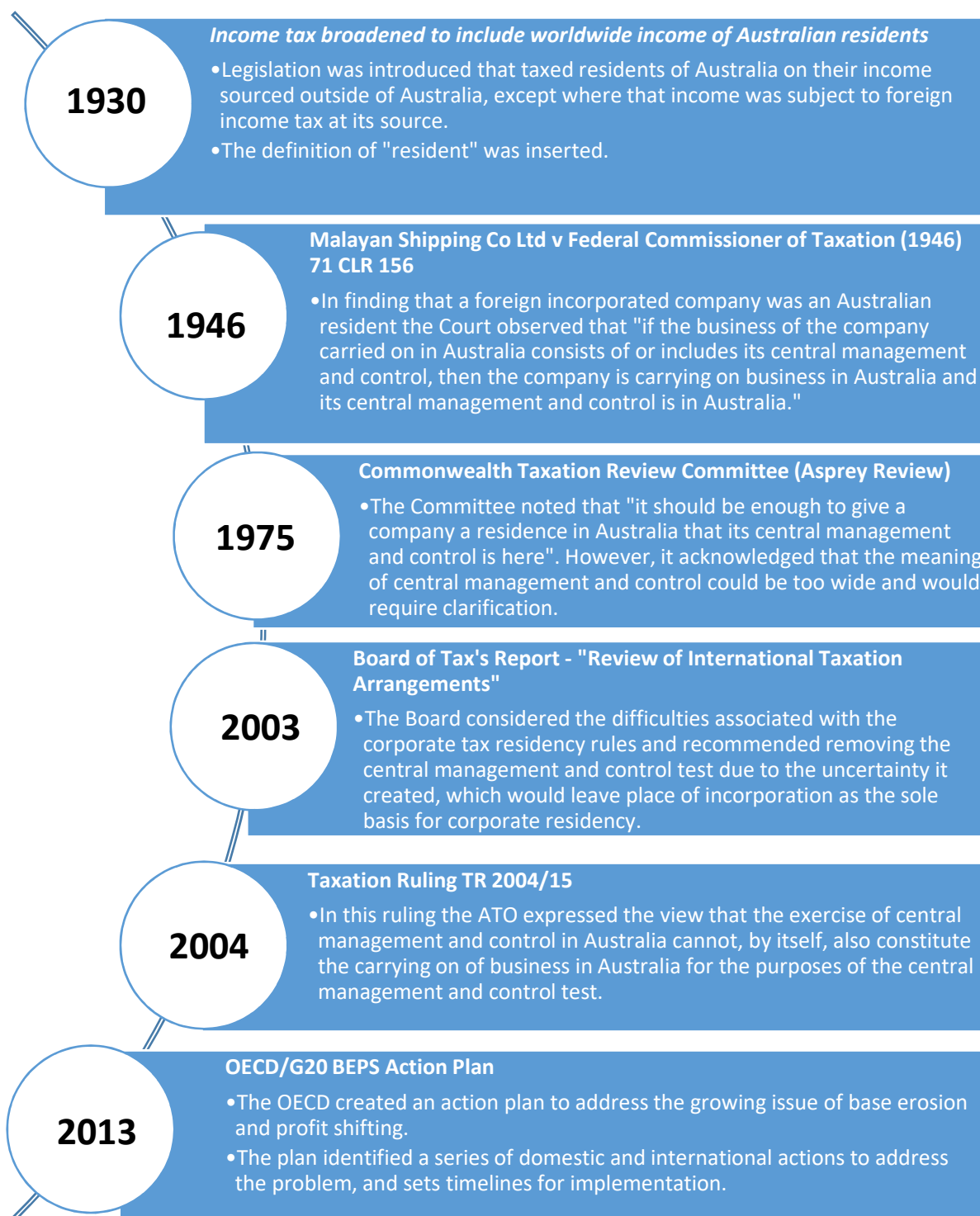
2018 change in ATO guidance materials

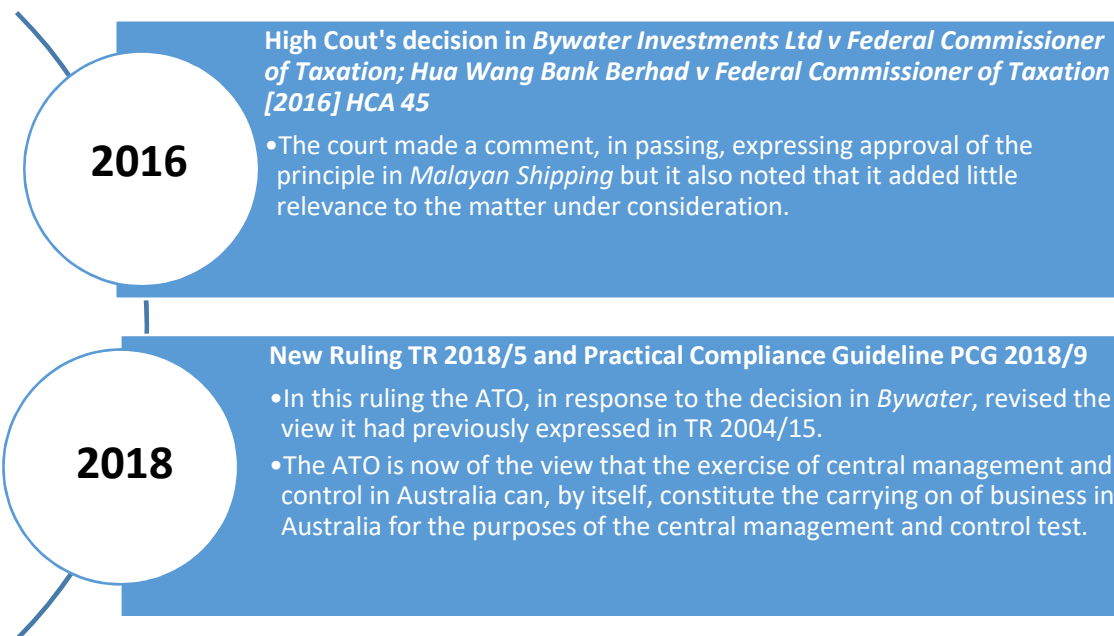
- 2.8 The Treasurer's request to the Board to undertake a review of the corporate tax residency rules was in response to a high level of industry concerns. These centred on the impact of modern corporate practices, the practical consequences of the *Bywater* decision (a case dealing with tax avoidance) and the subsequent publication of guidance materials by the ATO (referenced below), which have impacted the scope of the residency rules for all Australian companies with international operations. These guidance materials are:
- Taxation Ruling TR 2018/5 Income tax: central management and control test of residency (**TR 2018/5**);⁵ and
 - Practical Compliance Guideline PCG 2018/9 Central management and control test of residency: identifying where a company's central management and control is located (**PCG 2018/9**).
- 2.9 The Board's September 2019 Consultation Guide provides further detail on key events impacting the operation of the company residence rules. These events are summarised in the following diagram:

³ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, hereafter referred to as *Bywater*.

⁴ With flow on impacts for the voting power test, due to it also utilising the term "carries on a business".

⁵ Note that this replaced Taxation Ruling TR 2004/15 Income Tax: residence of companies not incorporated in Australia – carrying on business and central management and control.





2.10 From the diagram, the two key developments relevant to this review are:

- First, following the publication of TR 2004/15 the exercise of central management and control in Australia was not, of itself, considered sufficient to constitute the carrying on of business in Australia. As such, to be an Australian tax resident a company must carry on business in Australia in the first instance, and secondly central management and control must also be Australian based.
- Secondly, since the publication of TR 2018/5 the exercise of central management and control in Australia is, by itself, sufficient to constitute the carrying on of business in Australia (subject to any transitional relief provided).
- As a result of these developments, it is now possible for a foreign incorporated company to be an Australian tax resident even if the only activity conducted in Australia is the exercise of all (or a substantial degree) of that company's central management and control. This now means that all Australian companies with international operations must reconsider whether their foreign incorporated subsidiaries (which under the earlier ruling were not regarded as Australian residents) are now considered Australian residents under TR 2018/5.

2.11 The primary impetus for the Board's review includes:

- the change in the administration of the central management and control test following the *Bywater* decision; and
- changes in modern board practices, including through increased sophistication of communications technology.

CHAPTER 3: CURRENT DIFFICULTIES IN APPLYING THE CENTRAL MANAGEMENT AND CONTROL TEST

KEY POINTS

- The evolution of corporate governance practices and the widespread adoption of modern communication technology has created uncertainty in identifying where central management and control is being exercised. There is now a greater possibility that central management and control will be found to be exercised from a number of different locations *at the same time* in a given case.
- Previously these challenges were mitigated by the understanding that to be a resident a foreign incorporated company needed to have *both* operational activities conducted in Australia and central management and control in Australia. As a consequence of the revised ATO guidance following the *Bywater* decision the location of central management and control is considered to be determinative, exacerbating the pressures around locating central management and control.
- Companies have taken steps to manage the risk associated with a potential change of residence as a result of the changed ATO view (TR 2018/5 and PCG 2018/9).
- The steps taken have largely been to change the membership of the board of directors and the location of where Board meetings are held. This has led to significant costs for many taxpayers (both financial and costs associated with the weakening of corporate governance), as well as losses in efficiency and increases in 'red tape'. In many instances, unnecessary international travel has been undertaken.

- 3.1 Through the Board's consultations it has become apparent that, when combined with broader changes in modern corporate practices, the sequence of events referred to in the previous chapter has created uncertainty and/or increased compliance costs for many corporate groups in applying the central management and control test.
- 3.2 It has been suggested that this uncertainty could be dealt with under the current test by further judicial guidance. However, the Board considers that the current uncertainty is of a level that must be addressed in the short term – that is, before any future judicial guidance can be achieved.

- 3.3 This chapter further explores the factors underlying this uncertainty, including the tax consequences that are likely to arise if corporate residency changes and the actions employed by corporate taxpayers to minimise such risk and uncertainty around inadvertent changes to their tax residency.
- 3.4 In exploring these factors the Board references the fuller discussion in its September 2019 Consultation Guide which summarises the legislation, case law and administrative guidance on where central management and control is located.⁶ This long line of authority can be further summarised as:
- There is a need to identify the location of a company's central management and control by reference to the facts and circumstances of each case.
 - Ordinarily, the board of directors of a company makes the higher-level decisions which set the policy and determine the direction of operations and transactions of the company. It generally follows that the central control and management of the company will be located where the meetings of its board are conducted.
 - However, this is not always the case. For instance where directors merely act as a rubber stamp and abrogate their decision making power to an outsider, hence the need to consider the facts and circumstances of each case.

Changes in modern multinational corporate practices

- 3.5 Modern multinational corporate practices have changed dramatically since the central management and control rules were first implemented in Australia more than 90 years ago. As a consequence taxpayers have cited some uncertainty in identifying who makes the higher-level decisions of a company (e.g. is it still the board?), and have questioned whether the physical location of a board meeting is as relevant as it once was. Consistently across the Board's consultations three key changes were highlighted for their impact on corporate practices:
- the impact of the increased globalisation of the economy, including on the location of labour, value chains and the opening up of new markets;
 - the evolution of corporate governance practices; and
 - advancements in modern technology.
- 3.6 It is noted that the same changes are increasingly creating uncertainty around determining whether a business is being carried on in Australia.

⁶ Refer to Chapter 4 of the September Consultation Guide, which is reproduced below at Appendix D.

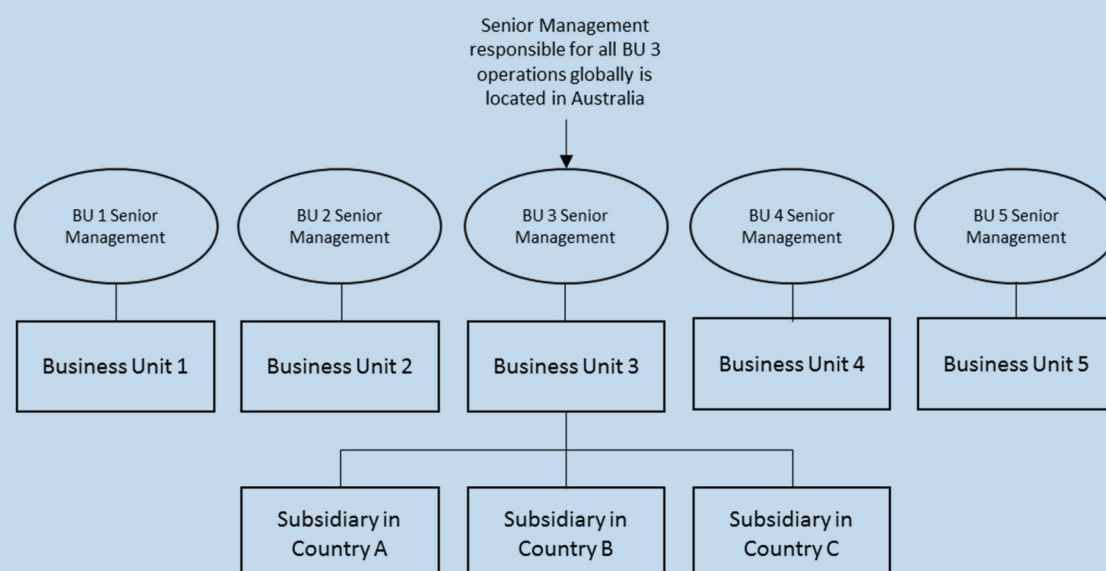
Globalisation and the evolution of corporate governance

- 3.7 The Board understands that for Australian multinational corporate groups determining central management and control at the *head* board level is generally not difficult - uncertainty and practical challenges typically arise further down the corporate structure at the subsidiary board level.
- 3.8 This is partly due to the impact of globalisation, which has seen corporate structures of all sizes increasingly spread across multiple jurisdictions as businesses seek to access global labour, new product markets and emerging business opportunities.
- 3.9 Challenges at the subsidiary board levels can be driven by a number of factors including:
- maturity of business operations in a particular country;
 - the nature of the workforce across different countries;
 - challenges in accessing talent with the requisite director skill set in every country of operation;
 - (non-tax) regulation including safety and corporate governance standards; and
 - country risk and cross group processes that seek to leverage regional or global capabilities to reduce cost and/or increase efficiencies (for instance centralising functions such as legal, human resources and shared services in a particular country).
- 3.10 In addition, as modern corporate governance practices have continued to evolve, a new set of complications has emerged in applying the central management and control test. For example, in terms of corporate governance it is considered 'best practice' for the parent company to establish high level group policies, as well as the establishment of committees to monitor compliance with those policies - that is, modern corporate governance now extends beyond the activities of the board.
- 3.11 For Australian based multinational groups there is a concern that such governance practices could be seen as a basis for attributing the central management and control of a foreign resident subsidiary to Australia. This is illustrated by the presence of business units and governance committees within the management model of a multinational corporate group.

Example 2 – Multinational corporate group organised according to its business units

It is common for multinational firms to centralise the senior management of a particular business unit or function within a country for a variety of commercial reasons. Prior to a subsidiary board considering a proposal, it is common for both the senior management of the relevant business unit and centralised group committees (such as investment and risk committees) to confirm that the proposal is within group strategy, compliant with group policies and within the group's risk appetite.

As a result, in making decisions about a foreign subsidiary's operational activities its board could be informed by senior management situated in another jurisdiction. For instance, in the diagram below, assume that Business Unit 3's Senior Management is located in Australia and manages the daily operations of Business Unit's subsidiaries in Countries A, B, and C.



In this example there is some uncertainty as to whether the central management and control of the subsidiary companies would be in either Australia or in countries A, B and C respectively.

- 3.12 In considering where central management and control is located, consultees raised questions around how to balance the operational responsibilities of business unit senior management/centralised committees with the legal role and responsibilities of directors on subsidiary boards.

Communications technology

- 3.13 Advancements in modern communications technology and its accessibility (for example, video conferencing apps and software – Skype, BlueJeans, FaceTime, Zoom and Google Hangouts Meet) have changed the manner in which many board meetings are now conducted. Companies seek to utilise this technology to reduce cost (for example, airfares and accommodation) and achieve efficiencies (including through maximising directors' and senior leaders' time).
- 3.14 Practically this means that modern technology allows board meetings to be conducted when directors are situated in different physical locations. This has become more evident in the way companies are responding to the Coronavirus pandemic and restrictions on international travel. The boards of companies are meeting more frequently (in some cases daily) via virtual mediums to make the necessary decisions to respond to the crisis.

- 3.15 From a tax perspective, this has increased the difficulty in identifying a single location where the exercise of central management and control can be attributed. There is also a greater possibility that central management and control will be found to be exercised from a number of different locations *at the same time*. Since the inception of the central management and control test this has always been a possibility, but it is the widespread and increasing use of modern communications technology in board meetings in particular that has had the effect of making this outcome a far more prevalent one.⁷

The impact on the central management and control test

- 3.16 Consultees noted that while modern corporate practices can create tensions in applying the central management and control test, these tensions were manageable under the previous ATO guidance released in 2004.⁸
- 3.17 The Board understands that this is largely due to the fact that under the ATO's 2004 guidance even if there was uncertainty as to where central management and control was located (or if in fact it was found to be in Australia), a foreign incorporated company was not considered to be an Australian tax resident if it did not have operational activities conducted in Australia – subject to some exceptions such as in the case of passive investment companies.
- 3.18 However, according to the revised ATO guidance in TR 2018/5 ascertaining the location of central management and control now assumes a paramount importance. That is, the location of central management and control is being interpreted as being *of itself* determinative of the Australian tax residency of a foreign incorporated company (without regard to whether there are any operational activities undertaken in Australia) and, when combined with changes in modern corporate practices, can either make identifying that location increasingly difficult or lead to anomalous outcomes.

Example 3 – NZ based manufacturing operations

The facts are the same as Example 1.

Applying the 2018 ATO guidance material

With the issuance of TR 2018/5 and the associated guidance in PCG 2018/9 there is a clear risk that the use of video/tele-conference by the two Australian directors may result in Australian tax residency being attributed to NZ Op Co.

As a result the company needs to fly both directors to New Zealand for each meeting, incurring additional financial cost and a loss in efficiency. Where the directors do not fly to New Zealand, and instead attend board meetings via video/tele-conference from Australia,

⁷ There has been an awareness of this issue for some time. See M Collett, 'Developing a New Test of Fiscal Residence for Companies' (2003) 26 UNSWLJ 622, 622.

⁸ Being TR 2004/15.

then applying the 2018 ATO guidance is likely to result in a change in the tax residency status of NZ Op Co (from a New Zealand tax resident to an Australian tax resident). This is despite the fact that neither NZ Op Co nor NZ Hold Co have a business or physical presence in Australia. They do not undertake any sales to persons/businesses in Australia, and only operate in New Zealand.

The implementation of the Multilateral Instrument by Australia and New Zealand alters the application of the corporate residence tie-breaker tests in the tax treaty arrangement between the two countries and adds additional complexity.⁹

- 3.19 The above example illustrates the *practical* difficulties in determining whether central management and control is located in Australia, in particular where decisions are exercised concurrently across multiple countries (including Australia). Whilst the ATO's PCG 2018/9 seeks to provide a practical solution to this situation by allocating central management and control to the country in which it has been exercised "to a substantial degree", the above example demonstrates that Australian residency may be triggered notwithstanding a foreign incorporated company is not carrying on any operational activities in Australia. This could mean that the residency of a company changes from meeting to meeting.
- 3.20 The Board received feedback through its consultations that this issue causes uncertainty for taxpayers, as it requires determinations to be made on a case-by-case basis as to whether an inexact threshold has been met. Evaluating where, by way of example, central management and control has been exercised to a substantial degree may require an assessment of the relative influence that is brought by individual directors on a meeting- by-meeting basis. Such a requirement is onerous (particularly for large groups) and difficult to substantiate.

Example 4 – NZ based manufacturing operations (continued)

The facts are the same as in Example 1, except one of the Australian directors of NZ Op Co retires, and is replaced by a New Zealand resident director. The Board now consists of two New Zealand resident directors and one Australian resident director.

Applying the 2018 ATO guidance material

The majority of directors reside in New Zealand and attend board meetings locally, thus central management and control of NZ Op Co is exercised to a substantial degree in New Zealand. As a result, the remaining Australian director no longer needs to fly to New Zealand for each board meeting to manage change of tax residency risk, but can instead now utilise video/tele-conference.

⁹ The ATO and New Zealand Inland Revenue Department have put in place administrative arrangements to allow eligible taxpayers to make a self-determination of residence for the purposes of the tax treaty.

- 3.21 Examples 3 and 4 demonstrates the ease with which the tax residency of a foreign incorporated company may change depending on whether directors attend board meetings in person (vs electronically) and the impact of small changes to the constituency of its board of directors. Furthermore, it highlights the current susceptibility of tax residence outcomes to changes that do not impact on the conduct of the underlying operational activities of the company.
- 3.22 As a consequence two corporate groups with identical operational activities in a foreign jurisdiction, who only differ over the decision on whether they physically fly directors to board meetings outside of Australia, can now trigger different tax residency outcomes. This raises questions around equity of treatment, and also creates integrity concerns due to the ease with which corporate residency may now be able to be manipulated (without impacting the underlying operational activities of a business).

Example 5 – decision making in subsidiary of a global corporate group¹⁰

USCo is a US incorporated company and is a wholly-owned subsidiary of Aust Co, an Australian listed company with numerous foreign subsidiaries.

USCo conducts business operations exclusively in the United States, which consist of the manufacture and sale of specialised equipment.

Aust Co requires USCo to comply with its policies in conducting its business in the USA.

Aust Co's board sets global policies containing highly detailed operational and trading policies that USCo's board must follow. These policies cover the entirety of USCo's activities.

USCo's directors are all American citizens and all board meetings are conducted in the United States. USCo's directors fully follow the directions from Aust Co's board in implementing the operational and trading policies in the United States (provided that they are lawful). Its directors do so without giving any consideration to the merits of those directions, that is, they do not independently assess USCo's business strategy but rather implement it.

This is an instance where a company's central management and control is being exercised independently, and apart from, its formal mechanism of corporate governance. There is little doubt that Aust Co's board is exercising the central management and control of USCo in Australia.

¹⁰ This illustration is based on Example 7 from PCG 2018/9.

Is USCo an Australian tax resident?

USCo is likely to be considered to be an Australian tax resident under the current view presented in TR 2018/5. This is despite USCo having no operational activities (i.e. carrying on business) in Australia

In contrast, USCo would have been a non-resident for Australian tax purposes under the former TR 2004/15. For USCo to be treated as an Australian resident under the former TR 2004/15 it would need to conduct some form of operational or trading activity in Australia. As a result, the application of the 2018 ATO guidance is likely to result in a change in the tax residency status of USCo (from a US tax resident to an Australian tax resident).

- 3.23 Example 5 demonstrates the primacy that central management and control now has in determining the tax residency status of all foreign incorporated companies. In contrast, prior to TR 2018/5 (following *Bywater*) there were limited cases where the exercise of central management and control would also constitute carrying on of business and therefore resulting in a foreign incorporated company being treated as an Australian tax resident (i.e. *Malayan Shipping*).

Tax consequences of a change in corporate residency

Foreign incorporated company (non-resident) becoming an Australian resident

- 3.24 The Board received extensive feedback from consultees about potential tax consequences associated with a change in residency status. Many consultees submitted that the threshold for Australian company residence had been altered under the revised ATO guidance. This is said to have led to an increased likelihood of a change in the residency status of a foreign incorporated company i.e. with it being treated as an Australian resident company rather than a non-resident.
- 3.25 In addition, there is a perception of an increased risk of volatility in a company's residence status (i.e. residence status may change repeatedly during an income year and across income years, thus magnifying the tax risks which a company will be required to manage).
- 3.26 Given that residence is a cornerstone of the tax laws the impact of a change in residence, albeit inadvertent or otherwise, can be significant. There may be immediate consequences that are triggered at the point in time when a foreign resident company becomes an Australian resident company, such as the automatic entry of that company into a tax consolidated group – and its income being subject to taxation on a worldwide basis by Australia. Other potential changes to the Australian tax treatment of the company (which would not be applicable had the company remained a foreign resident) include:

- Enhanced scope of the capital gains tax rules (worldwide versus Australian taxable real property).
- The prescribed dual resident rules.
- The investment manager regime.
- Various compliance obligations and penalties applicable to 'significant global entities'.
- Tax treaty implications, including those under the Multilateral Instrument.

3.27 The manner in which residency affects these items is discussed in Appendix B. That analysis indicates that significant consequences *do arise* if a foreign incorporated company becomes an Australian resident under the central management and control test.

Foreign incorporated company ceases to be an Australian resident

3.28 Whilst consultees have identified the primary risk arising from the central management and control test (as it is currently administered) as being the prospect of a foreign incorporated company inadvertently becoming an Australian resident, the Board has been made aware of a case where it is now being claimed that a foreign incorporated company no longer satisfies the central management and control test. There are four main consequences for a company which ceases to be an Australian resident:

- If the company is a member of a tax consolidated group then it will automatically cease to be a member of that group.
- If the company is generating tax losses then those losses cannot be used to shelter the assessable income of the tax consolidated group of which previously it was a member.
- Transactions between the company and other companies in the tax consolidated group will now be recognised for Australian tax purposes (whereas previously they were disregarded).
- Certain capital gains tax events may arise on the exit of the company from the tax consolidated group,¹¹ which may then give rise to taxable capital gains.
- Changes to the withholding tax arrangements in respect of certain payments of dividends, interest and royalties from Australia.

¹¹ Including capital gains tax events A1 and L5.

Effect on taxpayer behaviour from the current arrangements

3.29 The Board has observed changes in corporate taxpayer behaviour which are attributable to a combination of:

- the uncertainty now associated with the central management and control test; and
- managing the risk of crystallising significant tax consequences through inadvertently triggering a change in tax residence.

3.30 Representations made to the Board indicate that companies have had to take a range of steps to manage these risks following the *Bywater* decision and revised ATO guidance (TR 2018/5 and PCG 2018/9). The steps taken are mainly in the form of a host of conservative, costly and uncommercial corporate governance practices, which create unnecessary compliance costs and make it harder for businesses to operate.

3.31 Some of the practices that have been brought to the Board's attention include:

- Australian resident directors of foreign resident companies (prior to the impact of COVID-19) were travelling offshore to attend board meetings, notwithstanding that such board meetings could have been attended from Australia through the use of modern communications technology such as video conferencing.
- Australian resident directors are not attending the board meetings of foreign resident companies via video conferencing if they are unable to travel offshore.
- Australian based multinationals are restricting the numbers of, or completely removing Australian resident directors from, the boards of their foreign subsidiaries. In certain cases this has raised concerns with foreign regulators, particularly where a foreign subsidiary is operating in a highly regulated sector, for example the group chief executive officer is suddenly removed.
- Conversely, foreign resident directors of Australian resident companies are now travelling to Australia for board meetings rather than attend via video conferencing, to ensure that they do not inadvertently move Australian residency offshore.

3.32 The Board notes that whilst companies are adopting preventative measures to manage their tax risk, the ATO has not experienced a noticeable increase in private ruling applications concerning the central management and control test.

3.33 The Board is concerned that companies are incurring significant costs (in terms of both financial and costs associated with potential weakening of corporate governance) and losses in efficiency for no other purpose than to ensure that the tax residency of a foreign

incorporated company (with no operational business in Australia) remains outside Australia. In particular, limiting the appointment of Australian resident directors to the boards of foreign resident companies (or attendance at particular meetings) is problematic as:

- It is often the case that foreign resident directors are not as readily available and/or qualified for the role, relative to their Australian counterparts.
- ‘Start-ups’ and smaller corporate groups do not have a substantial globalised talent pool to draw appropriately skilled directors from.
- In cases of mergers and acquisitions it may not be possible to identify, vet and appoint replacement non-resident directors for some months.

3.34 The Board also notes that in many instances the incorporation of a subsidiary in a foreign jurisdiction may be mandatory, due to factors such as local regulatory requirements and securing an eligibility to borrow funds from overseas debt markets or financial institutions.

3.35 More recently consultees have highlighted the impact of the COVID-19 pandemic and restrictions being placed on international travel by governments and companies, and the potential effect on the central management and control test has been raised with the Board. The Board notes that the ATO has issued information to help address taxpayers concerns in this regard.¹² This highlights the risks of having rulings dependent on Australian directors attending offshore board meetings in pandemics.

¹² This information is available at www.ato.gov.au

CHAPTER 4: IMPROVING THE CORPORATE TAX RESIDENCY TEST

KEY POINTS

- The Board considers that the corporate residence rules are in need of reform.
- In the course of consultations two reform options emerged:
 - (1) The central management and control test would be modified to ensure the test is applied in two steps, consistent with its application under the former Taxation Ruling TR 2004/15 Income Tax: residence of companies not incorporated in Australia – carrying on business and central management and control.
 - (2) The residence of a company would be determined solely by its place of incorporation.

Proposed reform options

- 4.1 During consultation, the Board received overwhelming feedback and examples of the problems associated with the current operation of the corporate residence rules, including in relation to increased uncertainty and unnecessary red tape, costly and unproductive corporate governance practices and potential volatility of residence (with significant flow on tax consequences).
- 4.2 Consultees also provided various reasons why it would be impossible to revert to the former ruling which relied on regulation of administration only. It was noted that the ATO is bound to administer the law in accordance with the *Bywater* decision,¹³ and that this is not expected to change until such time as when the central management and control test is subject to further judicial consideration. As such an administrative solution was not possible. There was a consistent call from stakeholders for legislative reform of the corporate residence rules.
- 4.3 In evaluating the ATO's updated guidance material, the strong feedback from stakeholders and the terms of reference provided by the Government, the Board concluded the corporate residence rules are in need of reform. In considering how any such reform should look, the Board was also guided by the terms of reference and the need to consider any changes alongside international tax integrity rules.

¹³TR 2018/5 Income tax: central management and control test of residency, para 1

Basis of Australian tax residency – foreign incorporated company

- 4.4 It is important context to set out the justification for imposing Australian tax residency, and hence taxation of worldwide income, on a company that has been incorporated in a foreign jurisdiction.
- 4.5 In the view of the Board there must be a sufficient economic connection between Australia and the foreign incorporated company to justify treating the company as an Australian tax resident and exercising a right to tax its worldwide profits. Having regard to the consequences of tax residency and alternative approaches adopted internationally to determine economic connection,¹⁴ the Board is of the view that a sufficient economic connection will exist for these purposes when both of the following criteria are met:
- *core commercial activities* of the company are conducted in Australia; and
 - the company is centrally controlled and managed from Australia.
- 4.6 The critical questions asked by the Board through this review have been:
- Is this principle of ‘sufficient economic connection’ best reflected in the tax law through a central management and control test; or
 - Would an alternate approach provide a more certain outcome that better reflects modern corporate practices, whilst still maintaining the integrity of Australia’s tax system?

Reform options consultation paper

- 4.7 The Board’s December 2019 ‘Reform Options’ consultation paper outlined details of the following two reform proposals:
- **Reform option 1:** the central management and control test will be modified to ensure the test is applied in two steps, consistent with its application under the former ruling TR 2004/15.
 - **Reform option 2:** the residence of a company will be determined solely by the place of its incorporation. As such the current central management and control and voting power tests would be removed.
- 4.8 The Board also considered a proposal to replace the central management and control test with a ‘place of effective management’ test (the approach used in the ‘corporate

¹⁴ Please refer to ‘Chapter 6: Alternatives to the central management and control test’ of the Board’s September 2019 Consultation Guide for a summary of international approaches.

tie-breaker test' in the OECD Model Tax Convention on Income and on Capital). The Board received very little support for this proposal and concluded that this test would not address the current problems associated with the company residence rules.

Key considerations

4.9 In addition to complying with the Terms of Reference the Board considers it essential that the proposed reform options are also capable of:

- ensuring that a company's residency status is 'sticky', such that residency is not volatile and subject to short term changes;
- enhancing the veracity of the rules to ensure that a company's residency status is not determined solely on the basis of board meetings being attended in person, as opposed to meetings being attended via internet based conferencing platforms;
- accommodating developments in modern corporate governance;
- encouraging Australian business growth, including through removing unnecessary red tape and making it easier for businesses to operate;
- minimising the transitional and unintended tax impacts arising from any change in Australia's corporate tax residency settings;
- lowering integrity risks brought to the Board's attention that arise from the potential for the ATO TR 2018/5 central management and control test to be manipulated; and
- removing unnecessary compliance cost and business inefficiencies in managing Australian tax matters.

CHAPTER 5: RECOMMENDED APPROACH – MODIFICATION OF THE CENTRAL MANAGEMENT AND CONTROL TEST

KEY POINTS

- The ‘central management and control test’ should be modified in order to ensure that a foreign incorporated company will only be an Australian tax resident if it has a sufficient economic connection with Australia. Sufficient economic connection to Australia will be best demonstrated where together both the company’s core commercial activities are being undertaken in Australia and its central management and control is in Australia.
- Overarching guidance on the meaning of ‘core commercial activity’ should be provided in either the legislation or an explanatory memorandum and supplemented by accompanying ATO practical compliance guidance issued.
- Additional ATO administrative guidance may be required on the meaning of the term ‘central management and control in Australia’ in the context of modern corporate board practices.
- The ‘voting power test’ should be retained in the corporate residency rules at this time.

Reform option 1

Consultation feedback

- 5.1 The Board received a number of submissions expressing a strong preference for Reform option 1 (the two step approach) over Reform option 2 (using place of incorporation as the sole test).
- 5.2 Submissions in support of Reform option 1 noted the following advantages of this option:
- it is the most practical way to remedy the current difficulties faced by taxpayers;
 - it is an approach to determining corporate residency that is familiar to, and understood by, many taxpayers;
 - it is likely to have low transition complexity;
 - it does not increase tax integrity issues; and

- it protects the tax base from losses generated offshore (that would otherwise be disregarded) being used to reduce Australian tax payable.
- 5.3 The Board notes that several submissions did call for further clarification of the meaning of the terms “carries on business” and “central management and control” if Reform option 1 is implemented.
- 5.4 In contrast, several submissions raised the following concerns with Reform option 1:
- the test for corporate residency is not intended to be an integrity measure, and given the suite of existing integrity measures now included within Australia’s income tax law they questioned the need to retain the central management and control test; and
 - Reform option 2 provides a clear and unambiguous test of residence and a lower cost of compliance when compared to Reform option 1.
- 5.5 All consultees supported the proposal that any implementation of Reform option 1 would need to be through legislative change. Many consultees stated that it would be impossible to simply revert to the previous administrative guidance material (TR 2004/15), especially given the *Bywater* case and the ATO guidance issued since then.

The Board’s observations

Tax residence policy principle – sufficient economic connection with Australia

- 5.6 After weighing up the terms of reference and other factors outlined in paragraph 4.9 the Board is of the view that a central management and control test remains the best way to reflect the tax residence principle of ‘sufficient economic connection’ for foreign incorporated companies. In looking at how the current rules should be modified, the Board recommends that the current test is amended to ensure that the principle is applied in two steps that question:
- First, whether core commercial activities of a foreign incorporated company are undertaken in Australia. If yes, then:
 - Secondly, whether the central management and control of a foreign incorporated company is in Australia.
- 5.7 Historically the existing central management and control test was seen to embody both of the above criteria,¹⁵ but as a consequence of the revised ATO guidance following the *Bywater* decision this is no longer the case. This fact by itself is sufficient, in the Board’s

¹⁵ As reflected in TR2004/15, the “carries on business in Australia” limb was seen to determine whether core commercial activities are conducted in Australia, and the “central management and control in Australia” limb (along with the voting power test) was seen to determine whether substantive control is exercised from Australia.

view, to warrant a legislative change. The Board is also of the view that there is sufficient uncertainty and unnecessary compliance burden (and potential new risks for the tax system emerging) to further support the need for a legislative change.

- 5.8 In forming the view that a modified central and management control test is the preferred option, the Board was mindful of the trade-off between different elements of the terms of reference with supporting Australia’s tax integrity rules. Key issues around integrity are explained immediately below, whilst issues around certainty and the modernisation of the rules is discussed later in this Chapter.
- 5.9 The Board also had regard to the design principle that residence should be 'sticky' once established. It is important to provide certainty and remove scope for short term fluctuations, whilst still recognising that organisational change/drift may lead to a change to residency in the medium to long term.

Balancing integrity concerns

Integrity concerns with the current operation of the central management and control test

- 5.10 A tax integrity risk that the Board has been mindful to address is the susceptibility of the current operation of the central management and control test to attempts at manipulation. For example, tax residency is sought to be established in a country by flying directors to a particular location or installing local directors, regardless of the location of the business activities being undertaken. Whilst many perceive this risk relates to enabling foreign incorporated companies to avoid Australian tax residency (by simply flying Australian directors out of the country for board meetings), the Board heard suggestions that this risk does in fact extend in both directions. That is, relocating a foreign incorporated company’s tax residency to Australia through simply moving all board meetings here (with no change to the underlying business being carried on offshore) could create an opportunity to bring foreign generated operating losses (that would otherwise be disregarded) into the Australian tax system.
- 5.11 This risk has become particularly clear as a consequence of the COVID-19 pandemic. The Board understands that there are foreign subsidiaries of Australian companies now making material operating losses.
- 5.12 Currently, these foreign subsidiary losses do not offset Australian tax payable. However, where tax residency can be easily migrated to Australia through, for example, changes in director composition (without any change to the underlying foreign business) this creates a new risk to the Australian tax base.
- 5.13 The Board is mindful of balancing these integrity concerns with the existing judicial consideration of the meaning of “central management and control”. The concept has shown itself to be sufficiently robust to deal with different situations – such as the situations in *Malayan Shipping* and *Bywater*, where central management and control was

either accepted to be or found to be in Australia notwithstanding all or the majority of the directors being resident offshore.

Potential new integrity concerns

- 5.14 Whilst in agreement with consultees that a bright line test (such as one based on incorporation only) would provide complete commercial certainty, the Board remained concerned with integrity matters, especially given Australia's high corporate tax rate versus other countries.¹⁶ The increasing corporate tax differential relative to other countries, coupled with an incorporation only test, could be expected over time to incentivise what would otherwise have been Australian resident companies to incorporate offshore.
- 5.15 Some stakeholders argued that other aspects of the Australian tax system provide the necessary safeguards to move to place of incorporation. They cited provisions such as the controlled foreign companies (CFC) rules, transfer pricing rules or provisions that tax the income of Australian permanent establishments of foreign resident companies. However, through the Board's consultation examples were provided of real risks that would not be covered by these provisions, particularly in light of the tax differential between Australia and other nations.
- 5.16 The Board was also concerned that an incorporation only rule coupled with Australia's high corporate tax rate may provide an incentive for multinationals to reduce their overall effective tax rates through relocating activities or profits out of Australia, with broader non-tax implications for Australia.

Start date and review

- 5.17 The majority of consultees indicated a preference for Reform option 1, if implemented, to apply retrospectively from 15 March 2017 (being the date on which TR 2004/15 was withdrawn) or be subject to some form of transitional arrangement so that taxpayers are not disadvantaged. The Board notes that for many taxpayers this approach would align with the transitional relief afforded by the ATO in its current administrative guidance.¹⁷
- 5.18 If the Government agrees to implement the Board's reform option 1 (below) then the Board believes that the reform should be able to be applied from 15 March 2017. The Board notes that this would be an equitable outcome, given the reform is aligned to the previous practical application of this aspect of the company residence rules. In comparison, a transitional rule where no taxpayer is disadvantaged is likely to involve

¹⁶ Refer to the table at <https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>

¹⁷ PCG 2018/9 Central management and control test of residency: identifying where a company's central management and control is located, [102] – [104].

additional complexity and ‘red tape’. It also addresses the risks associated with the current potential for volatility in a company’s residence status outlined in paragraph 3.22.

RECOMMENDATION 1

The ‘central management and control test’ should be modified to ensure that for a foreign incorporated company to be an Australian tax resident there needs to be a sufficient economic connection to Australia.

Sufficient economic connection to Australia will be best demonstrated where together both the company's core commercial activities are being undertaken in Australia and its central management and control is in Australia. Central management and control in Australia, by itself, will not be sufficient except in very limited circumstances (such as with certain holding companies).

The new rules should apply prospectively and as soon as possible after receiving Royal Assent, but a foreign incorporated company should also have the option to choose for the rules to take effect from the date TR 2004/15 was withdrawn (15 March 2017).

The new rules should be subject to a Government review three years after receiving Royal Assent.

Other issues raised during consultation

Minimising uncertainty – the meaning of core commercial activities undertaken in Australia

5.19 In amending the corporate residency rules, stakeholders advocated for a legislative reinstatement of the operation of the central management and control test as described under TR 2004/15. However, the Board is concerned that this may not provide sufficient certainty or alignment with modern businesses, particularly with respect to the “carries on business in Australia” limb of the current rules.

5.20 Historically, these words were interpreted as referring to an assessment of whether the major operational activities of a business were located in Australia, with an acknowledgment that for some companies that are more passive in nature the same factors may be relevant in assessing the location of operational activities and central management and control.¹⁸

¹⁸ TR 2004/15, para 9-12.

- 5.21 However, comments in two High Court decisions (*Bywater* and *Malayan Shipping*) have now created divergent views and hence real uncertainty around whether the existence of central management and control in Australia, of itself, means a company is carrying on business in Australia.¹⁹ Similarly, there is a view that indicates that the threshold requirement for merely “carries on business” is quite low.²⁰
- 5.22 Against this interpretative uncertainty, the nature of business itself has changed dramatically over the last two decades. In Chapter 3 there is a discussion of changes relating to advancements in technology and increased globalisation of the economy, including on the location of labour, value chains and from the opening up of new markets. Example 2 is a relatively common structure for large outbound Australian multinationals where the senior management of a particular business unit is centralised within a particular country for commercial reasons and central group functions (such as legal or finance) in another country, both of which are potentially different to the trading location of the business.
- 5.23 Similarly, changes in technology and the opening up of foreign markets have facilitated greater expansion of small and medium Australian businesses offshore.
- 5.24 As a consequence, the Board questions whether the “carries on business in Australia” limb is still the appropriate means of indicating whether, in fact, the core commercial activities of a foreign incorporated company are conducted in Australia. To provide better clarity of the intended meaning (and greater alignment with modern business) consideration should instead be given to reformulating this limb to more accurately reflect the fundamental underlying criteria that it seeks to represent.
- 5.25 As part of its thinking of a reformulation the Board sought feedback in the Reform Options Paper as to whether the meaning of “carries on business in Australia” should be defined legislatively, or guidance provided through other means.

Consultation feedback

- 5.26 Consultees shared a real divergence of views on the need to provide a meaning for the concept currently expressed as “carries on business in Australia” in response to the question raised in the Reform Options paper.
- 5.27 Several consultees were in support of legislatively defining the term, whereas other submissions indicated there was no need to define the term. Some suggested that defining the term would add more complexity (and hence more difficulty) to the law. One consultee noted that determining whether a business has been carried on in a particular jurisdiction is highly dependent on the facts and circumstances of each case, and that the

¹⁹ Refer to Appendix D for a discussion of this matter.

²⁰ Refer to the discussion in Taxation Ruling TR 2019/1 *Income Tax: when does a company carry on business?*, though it should be noted that this ruling is concerned with the statutory expression “carries on a business” in section 328-110.

relevant threshold requirements may vary considerably across different types of business, as is readily apparent when comparisons are made between digital commerce and more conventional modes of business enterprise.

5.28 Similarly there were differing views as to whether the issue could be addressed through administrative guidance, with many citing the current uncertainty as evidencing why administrative guidance was not the answer. Some consultees did, however, suggest that administrative guidance may be more appropriate, with two key matters capable of being addressed in this way:

- A *de minimis* threshold to ensure that incidental or ancillary activity does not, by itself, lead to a finding that business is being carried on in Australia;²¹ and
- clarification of the status of ‘pure’ holding companies and their activities – being passive investment entities that conduct no operational activity other than the acquisition, holding and disposal of investments in shares.

5.29 Several submissions expressed the view that the central management and control of a ‘pure’ holding company could not be separated from the business being carried on by the company and that any clarification of “carries on business” should reflect this, whereas a number of other consultees suggested including a specific rule for holding companies.

The Board’s observations

5.30 As discussed above, the Board is now of the view that the “carries on business in Australia” limb of the central management and control test should be reformulated so that it more accurately reflects whether the core commercial activities of a foreign incorporated company are conducted in Australia. As a result some aspects of the consultation feedback (given it specifically related to the existing words in the legislation) are arguably not relevant. On the other hand any reformulation of this limb of the test would remain a ‘facts and circumstances’ test that entails similar lines of inquiry, and therefore the same issues remain.

5.31 As a consequence, the Board is of the view that that there is a strong case for clarifying the circumstances under which the core commercial activities of a company can be said to be undertaken in Australia. At the very least this would involve something more substantial than the post *Bywater* administrative interpretation of “carries on business in Australia” to include some form of operational or trading activity.

²¹ Incidental or ancillary activity could include, by way of example, ‘back office’ functions that are centralised in Australia such as record maintenance, regulatory compliance, accounting and IT services.

Factors to consider in determining the location of core commercial activities

5.32 To this end, the Board considers that factors relevant when assessing whether the core commercial activities of a foreign incorporated company are undertaken in Australia include:

- the nature of the business carried on by the company;
- the location of staff and assets employed in the conduct of the core business activity of the company in both Australia and abroad;
- the size of the company;
- the sophistication of the company's corporate governance practices;
- any separation between strategic management and operational control of the business;
- the composition of the company's board and any additional roles held by directors; and
- the distinction between activities that are core to the conduct of the business and those that are preliminary or ancillary, such as general support functions.

5.33 Included in Appendix C are a number of examples that illustrate how the above factors may be applied in practice.

5.34 Reference was made in paragraph 5.28 to the desirability of administrative guidance concerning a *de minimis* threshold, so as to ensure that the conduct of incidental or ancillary activities in Australia does not lead to a finding that a foreign incorporated company carries on business in Australia. The Board notes that the same approach could also be used as a means of differentiating between what does, and what does not, constitute core commercial activities.

5.35 The Board has recommended a legislative modification to the central management and control test that reflects the need, as a prerequisite for Australian tax residency, for a foreign incorporated company to conduct its core commercial activities in Australia. As Australian tax residency gives rise to significant consequences it is important to ensure that only certain activities of a substantive nature will be designated as core commercial activities. If this is not the case then it leaves open the possibility that this requirement could be met by any type or degree of activity conducted in Australia.

How best to provide this certainty?

5.36 As noted above, there are competing arguments around whether to (and if so, how best to) provide greater certainty as to what is meant by whether core commercial activities of a foreign incorporated company are undertaken in Australia. In weighing up these

competing arguments, the Board is of the view that in order to prevent the current uncertainty being replicated with a reformulated limb, the legislation and extrinsic materials do need to provide overarching guidance on the meaning of this concept (however, expressed in the legislation).

- 5.37 The form of this guidance should be determined through further consultation. It must, however, be sufficient to enable the ATO to provide supplementary practical compliance guidance on distinguishing between core commercial activities and *de minimis* activities (and that includes examples that can be updated to reflect future changes in the nature of commerce).

Holding companies

- 5.38 The Board considered the merits of including a specific rule to deem Australian tax residence for holding companies. However, the Board did not support this approach as it would add unnecessary ‘red tape’ to the tax laws and may have unintended consequences.

- 5.39 The residency status of holding companies was previously addressed in (the now withdrawn) TR 2004/15.²² The Board is not aware of any concerns arising from the former approach. The Board therefore recommends addressing this issue through administrative guidance consistent with the previous ruling.

RECOMMENDATION 2

Overarching guidance of the circumstances under which the core commercial activities of a company can be said to be conducted in Australia should be provided in the legislation and extrinsic materials.

This should be supplemented with administrative practical guidance that includes the treatment of ‘holding companies’ and the need for a *de minimis* threshold.

²² Under the withdrawn ruling the location of central management and control was considered to be indicative of where the company carries on business.

Minimising uncertainty - the meaning of ‘central management and control’

Consultation feedback

5.40 A small number of submissions supported the inclusion of a definition for the term central management and control in the tax laws. However, the submitters suggested differing approaches to how this could be achieved, such as:

- a pragmatic approach resulting in the location of central management and control being where the majority of Board meetings are held. The location of the board meeting would be determined by the location of the physical presence of the majority of the directors; or
- the focus of the definition should be on the commonly understood meaning of central management and control, arising from case law, and focussing on high level decision making and good corporate governance. This should be supported by examples in the explanatory material. The definition should specifically exclude the concept of carrying on business.

The Board’s observations

5.41 The Board does not consider that there is a need to reformulate the “central management and control in Australia” limb of the central management and control test - there is significant case law setting out what constitutes the central management and control of a company.²³ However, the Board believes that there is scope to enhance its alignment with modern business practices through additional administrative guidance.

5.42 Consistent with the Board’s first design principle (see paragraph 5.9) it is important to ensure that a company’s residency status is ‘sticky’, such that short term changes do not trigger a change in residency and likewise that a company’s residency status is not solely premised on whether a director attends board meetings in person or via video link.

5.43 The Board understands that there is a view within the tax community that the location of central management and control can, under TR 2018/5, be established (or moved) through physically flying directors to board meetings in different countries. In supporting

²³ Refer to paragraph 5.35.

this view, previous ATO guidance designed to provide compliance relief has been cited,²⁴ as has the ‘relevant considerations’ included in current ATO guidance.²⁵

- 5.44 The COVID-19 pandemic has highlighted practical issues with an approach that is weighted to directors flying to board meetings (and by extension a residency test based purely on central management and control without reference to the core commercial activities of a business). In providing a moratorium the ATO has noted:

The spread of COVID-19 has resulted in overseas travel bans and restrictions and a high degree of uncertainty generally around international travel. You may be concerned about these effects on your corporate residency status because of a need to change locations of board meetings or where directors attend them from.²⁶

- 5.45 Not only does a heavy reliance on physical attendance lack veracity and run counter to modern board practices, in a COVID and post environment, a test linked to global travel has limited practical utility. Even after the COVID-19 pandemic has passed it is doubtful whether the practice of flying directors around the world will immediately recommence, given that ‘business as usual’ practices regarding international travel will not reassert themselves for some time.

- 5.46 The Board agrees that historically the physical location of directors during board meetings was highly relevant in evidencing a corporate board’s decision making process. However, the way in which businesses operate now has changed significantly, particularly as a function of the evolution in technology. The changed nature of a modern business necessitates consideration of additional factors in determining where company's central management and control is exercised. These factors may include:

- The composition of the board and any additional roles directors may hold;
- Any impact of the ultimate ownership of the company;
- The impact of regulatory requirements; and
- The residency and/or physical location of directors in exercising their duties.

²⁴ “In order to reduce uncertainty, the Commissioner as a matter of practical compliance will accept for those companies whose central management and control is exercised by a board of directors at board meetings that the central management and control is in Australia if the majority of the board meetings are held in Australia. The exception to this is cases where the circumstances indicate an artificial or contrived central management and control outcome”, TR2004/15 para 15

²⁵ “The matters most likely to influence a court's decision, as to where those who control and direct the operations of a company do so from, are: where those who exercise central management control do so, rather than where they live; where the governing body of the company meets; where the company declares and pays dividends; the nature of the business and whether it dictates where control and management decisions are made in practice; minutes or other documents recording where high-level decisions are made”, TR 2018/5, para 36

²⁶ Refer the ATO’s website <https://www.ato.gov.au/General/COVID-19/COVID-19-frequently-asked-questions/International-business-frequently-asked-questions/#CentralmanagementandcontrolCMC>

- 5.47 By placing a lesser emphasis on physical attendance at board meetings the prospect of numerous changes to a company’s tax residency status is decreased. This, combined with a focus on where a company’s core commercial activities are undertaken, seeks to ensure that changes in a company’s tax residency status will only arise where a substantive and enduring change to that company’s circumstances has taken place.

RECOMMENDATION 3

The ATO should consider providing additional practical guidance on the meaning of the term ‘central management and control in Australia’ to provide greater alignment with modern business practices.

The voting power test

- 5.48 The review considered whether there is any compelling reason for retaining the third residence test known as the ‘voting power’ test.

Consultation feedback

- 5.49 It is clear from the feedback received by the Board that this test is rarely contemplated or applied in practice. Different views were offered as to why this is the case including:
- the incorporation and central management and control test (under ATO TR 2018/5) were doing all of the ‘heavy lifting’ in determining corporate residency; and
 - the ability to apply this provision has been reduced as a consequence of the decision in *Patcorp Investments Limited (formerly Patrick Corporation Limited) & Ors v FCT* 76 ATC 4225, which limited application by reference solely to a company’s register (as opposed to the ultimate beneficial ownership)
- 5.50 The vast majority of the submissions and consultees who addressed the issue suggested that the retention of the test added ambiguity, and provided no further integrity for the tax system.
- 5.51 Most consultees supported the removal of the voting power test. A small number suggested that the test could be revised to apply to the ultimate shareholder or controller as opposed to the immediate shareholder to address concerns with its application; or that it should be retained until the implications of its removal have been fully explored alongside any reform of the central management and control test.

The Board's observations

- 5.52 The Board considered whether removal of this test would create compliance savings for companies, however, due to the lack of evidence of this test being relied upon to confer Australian residence for a company, there was no evidence of savings.
- 5.53 While the Board did not identify increased tax integrity issues associated with the removal of this test the Board had reservations around potential risks associated with certain subsets of private company groups.²⁷ The existence of the voting power test may temper this risk. Thus the Board is reluctant to recommend the outright removal of the test at this time given the lack of evidence it has been able to obtain on the effect of removal, particularly whether its removal would create unintended consequences for the tax system more broadly.
- 5.54 The Board notes that any change from a “carries on business” to “core commercial activities” test should be applied to the voting power test. If the Government agrees to implement the Board’s reform options, the effect of this change (alongside a consideration of any potential risks associated with the removal of the voting test) should be further explored as part of the recommended Government post implementation review of these rules.

RECOMMENDATION 4

The ‘voting power test’ should be retained at this time.

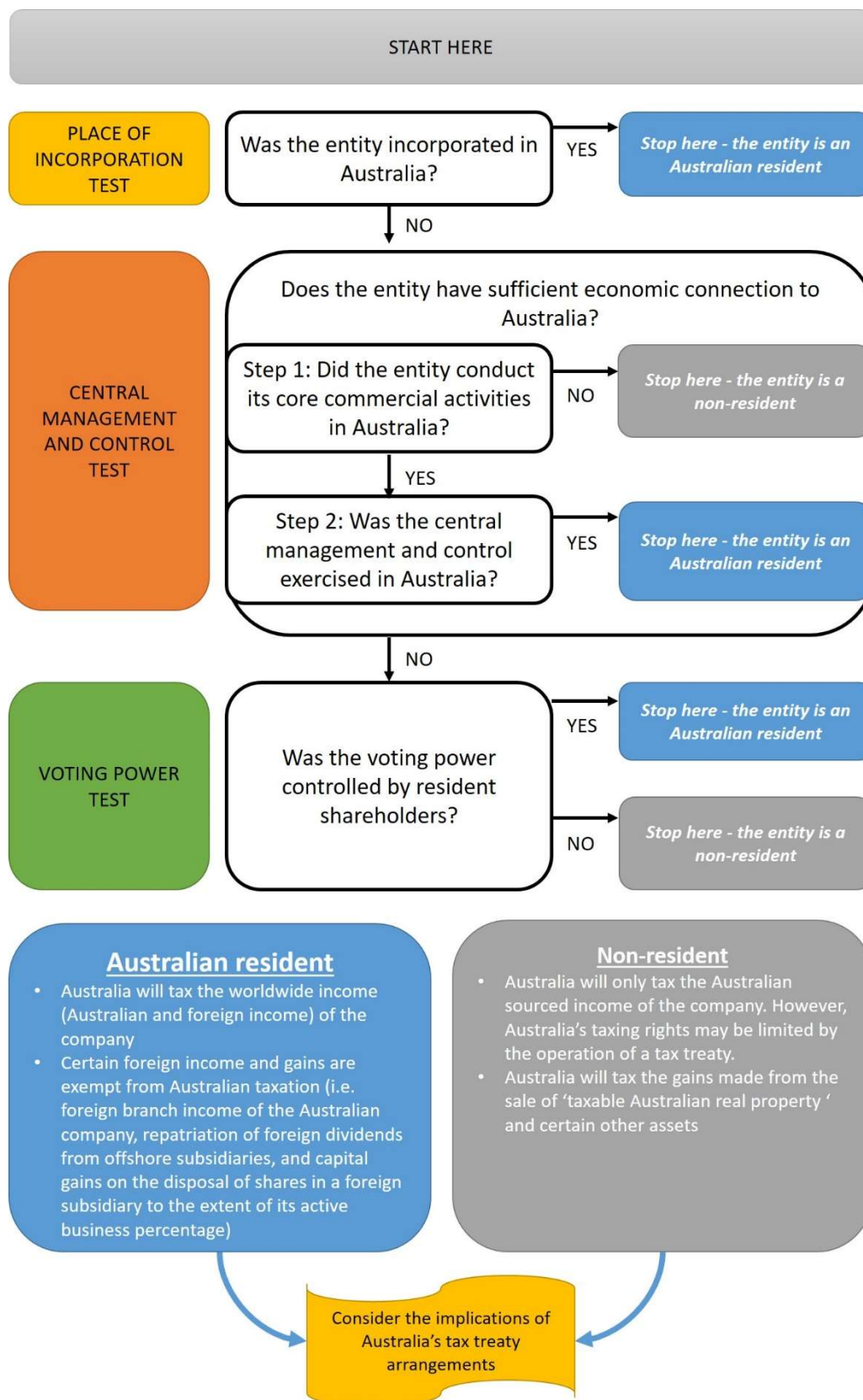
Any change from the wording “carries on business” to referencing core commercial activities in the ‘central management and control test’ should likewise be applied to the ‘voting power test’.

The Board’s recommended corporate residence model

- 5.55 The Board has prepared a flowchart outlining how the recommended residence rules will apply in practice:

²⁷ This concern is presumably reflected in the fact that the ATO’s ongoing compliance approach only extends to a company that is a member of a public group, as detailed in paragraph 107 of PCG 2018/9 Central management and control test of residency: identifying where a company’s central management and control is located.

Board of Tax: Recommended corporate residency rules flowchart



Other matters raised

- 5.56 During the review the Board was made aware of concerns relating to the application of the ‘controlled foreign companies’ rules. The issues relate to the design and operation of the ‘listed country’ rules, particularly as many of the listed jurisdictions have reformed their tax bases or significantly lowered their corporate tax rates since the controlled foreign company rules were introduced. The Board was also made aware of the increasing importance of intangible assets and the practical difficulties that arise for Australia’s international tax rules; in particular for the controlled foreign companies and transfer pricing rules
- 5.57 The Board acknowledges the practical difficulties associated with the application of, and the potential tax gaps which can arise under, the controlled foreign companies and transfer pricing rules for taxpayers and the administration. The Board has not undertaken a detailed analysis of the concerns raised or quantified the extent of the problem. However, the Board notes that these concerns do not impact on how the residence of a foreign incorporated company is determined (the subject of this review).

OECD digital economy work

- 5.58 A small number of consultees questioned whether reforms should be deferred until the OECD completes its work on the tax challenges arising from the digitisation of the economy. There was overwhelming support by consultees for the reforms to the company residence rules to proceed as a matter of urgency.
- 5.59 The Board has maintained a watching brief over OECD developments since work on the ‘digital economy’ began. Based on the OECD’s work to date, the Board has not identified any potential adverse impact on Australia’s company residence rules although it notes that the OECD’s work may effect a significant change to the international tax framework more generally.

OBSERVATION 1

The Board will continue to monitor the OECD ‘digital economy’ work as reforms to international taxing norms may have an impact on company residence concepts. Any such reforms should be taken into account as part of the recommended Government review of the new residency rules.

CHAPTER 6: OTHER OPTIONS CONSIDERED

KEY POINTS

- While there was support for Reform option 2 (the residence of a company would be determined solely by the place of its incorporation) on the basis that it would simplify the residence test and provide certainty, other consultees submitted that any benefits would be outweighed by the costs associated with revised integrity rules.
- A place of management or place of effective management would not ease the uncertainty and burden currently placed on corporate taxpayers.

6.1 In addition to the recommended approach in Chapter 5, the Board also considered alternative reform options which are outlined below.

Determining residence solely by place of incorporation (Reform option 2)

Consultation feedback

- 6.2 The Board received a number of submissions that strongly supported the determination of a company's residence solely by a place of incorporation test.
- 6.3 A number of consultees suggested that this reform option would greatly simplify the test of corporate residence and remove uncertainty.
- 6.4 In addition, some consultees submitted that this reform option would also allow taxpayers to freely utilise modern governance practices and communications technology, which lower the financial and environmental cost of governance.
- 6.5 Consultees have also commented that an incorporation-only test would be more aligned with Australia's international tax policy settings for companies (which are largely premised on a capital import neutrality benchmark) and more consistent with Australia's self-assessment tax system.
- 6.6 Several submissions also noted that Australia had recently introduced a range of integrity and transparency measures (i.e. diverted profits tax, multinational anti-avoidance law and tax transparency measures; including country-by-country reporting) to protect Australia's corporate tax base. Furthermore these integrity rules, along with Australia's controlled foreign company rules, transfer pricing rules and the general anti-avoidance rules, are sufficiently robust to address any integrity concerns associated with a form based test of residence.

- 6.7 However, other consultees considered that there would be a clear need to strengthen existing integrity rules and the possibility of new rules to protect the tax base if this reform option was pursued. In particular, several suggested the scope and application of the controlled foreign companies rules would need to be reconsidered as the tax rate differential between Australia and other lower taxed countries combined with a lower residence threshold provides an incentive to invert company structures.
- 6.8 Consultees also noted an ‘incorporation-only’ test has very little precedence internationally, with the only large economy using this approach being the United States where recent corporate tax cuts had taken place which had reduced the incentive for manipulation.

The Board’s observations

- 6.9 The Board acknowledges that this reform option would minimise uncertainty and provide alignment with modern Board practices (both factors to be considered under the Terms of Reference). However, as noted in Chapter 5, when compared to the existing rules and other reform options, an ‘incorporation-only’ test presents heightened integrity risks. As consultees noted, whilst it may be possible to implement new integrity rules to mitigate these heightened risk, this would introduce further complexity (and most likely a new set of uncertainties) into the law.
- 6.10 By way of example, it was highlighted to the Board that a number of the existing rules designed to protect the integrity of Australia’s tax system against multinational profit shifting have been premised upon the company residence rules having a broad scope (for example the controlled foreign companies rules). To the extent that the company residency rules were narrowed under an incorporation only test, there would be a resulting need to further strengthen these existing rules, adding further complexity to an already complex corporate tax system.
- 6.11 On this basis, the Board considers that the risk to the integrity of the system outweighs the benefits associated with this reform option. Accordingly the Board does not recommend proceeding with this reform option.

RECOMMENDATION 5

The Board recommends that basing residency solely on a place of incorporation test should not be adopted.

Place of management / place of effective management test

- 6.12 The review also considered replacing the central management and control test with the international tax treaty standard of “place of management” or “place of effective management” (POEM).

- 6.13 This proposal did not receive any support during consultations. Most consultees submitted that the introduction of a new test and terminology in the domestic law would lead to increased uncertainty. The proposal would also not address the concerns raised with the current application of the central management and control test.
- 6.14 The Board considers that adopting a test based on the place of management or place of effective management test would still require an ongoing analysis of specific facts and circumstances. Given the increase in use of telecommunication technology and a global workforce, the Board has considered such reform option to be inconsistent with modern corporate governance practices.

RECOMMENDATION 6

The Board does not recommend adopting a corporate residency test based on place of management or place of effective management.

APPENDIX A: CONSULTATION PROCESS AND PARTICIPANTS

In September 2019, the Board released a Consultation Guide describing the scope of the review and presented a series of questions to identify the key difficulties being encountered and possible reform options. The Board received 14 written submissions (four of which were confidential) from the following organisations during the consultation period:

- Joint submission by the Business Council of Australia and the Corporate Tax Association
- Chartered Accountants Australia and New Zealand
- Corporate Taxpayers Group
- EY
- Financial Services Council
- Greenwoods & Herbert Smith Freehills
- KPMG
- Law Council of Australia
- Pitcher Partners
- Powerco

In October 2019, the Board undertook a series of face-to-face roundtable meetings with over 40 participants in Melbourne, Perth and Sydney. Organisations represented at the roundtables included:

- A&A Tax Legal Consulting
- Australian Super
- Barrick Gold
- BHP
- Chartered Accountants Australia and New Zealand
- Corporate Tax Association
- Deloitte
- EY
- Financial Services Council
- Grant Thornton
- Greenwoods & Herbert Smith Freehills
- Jones Day
- K&L Gates
- Law Institute of Victoria

- Law Council of Australia
- Lendlease
- Macquarie Bank
- Pitcher Partners
- PwC
- REA Group
- The Tax Institute
- Viva Energy Australia
- Woodside

In December 2019, the Board released a Reform Options Paper to canvass feedback on two reform options which had emerged from the Consultation Guide and roundtable discussions. The Board received 13 written submissions (four of which were confidential) from the following organisations during the consultation period:

- Joint submission by the Business Council of Australia and the Corporate Tax Association
- Corporate Taxpayers Group
- EY
- Financial Services Council
- KPMG
- Law Council of Australia
- Pitcher Partners
- Powerco
- The Tax Institute

APPENDIX B: FOREIGN INCORPORATED COMPANY BECOMES AN AUSTRALIAN RESIDENT – IMPLICATIONS OF CONCERN

Tax consolidation

Australia has a tax consolidation regime which allows a group of wholly-owned companies to ‘consolidate’ and hence be treated as a single entity for income tax purposes.²⁸ This has numerous advantages. Intra-company transactions within a tax consolidated group are disregarded, and a single income tax return is lodged for the entire group.

A company must be a wholly-owned Australian resident in order to join a tax consolidated group as a subsidiary member.²⁹ A foreign resident company cannot, therefore, join a consolidated group. Two issues may arise in the event that a foreign incorporated company that is wholly-owned by a consolidated group becomes an Australian resident (or a “prescribed dual resident” – discussed below) under the central management and control test.

First, on becoming an Australian resident the company will automatically join the tax consolidated group. Where this is the case the assets of the company are deemed to have been acquired by the consolidated group, and complex calculations will be required in order to ‘reset’ the cost of the assets for tax purposes.³⁰

Secondly, in certain circumstances the outcome of the central management and control test may cause a company to become a prescribed dual resident as well as an Australian resident.³¹ As is the case with a foreign resident, a prescribed dual resident cannot join a tax consolidated group.³² In such a case the payment of an unfranked dividend from the prescribed dual resident to the consolidated group may result in double taxation, as the unfranked dividend will be included in the taxable income of the consolidated group. This outcome would not arise if the company were an Australian resident but not a prescribed dual resident, in which case the company would form part of the consolidated group and the payment of the dividend disregarded. Furthermore, there is a ‘foreign non-portfolio dividend’ exemption in the income

²⁸ Income Tax Assessment Act 1997 (Cth) section 701-1.

²⁹ Income Tax Assessment Act 1997 (Cth) subsection 703-15(2).

³⁰ Income Tax Assessment Act 1997 (Cth) division 705.

³¹ Refer to the definition of “prescribed dual resident” in subsection 6(1) of the *Income Tax Assessment Act 1936* (Cth). If, for example, a foreign incorporated company satisfies the central management and control test but is deemed to be a foreign resident for the purposes of a tax treaty then the company will be a prescribed dual resident.

³² Income Tax Assessment Act 1997 (Cth) subsection 703-15(2).

tax legislation that applies in certain circumstances to exclude *foreign dividends* (i.e. paid from foreign companies) from the taxable income of an Australian shareholder,³³ but a current bill before Parliament proposes that this exemption will not apply where the dividend is paid by a dual resident that has been allocated under an Australian tax treaty tie breaker to the other party to the treaty.³⁴

Tax treaties

A ‘tax treaty’ is an agreement between Australia and a foreign jurisdiction that allocates taxing rights between Australia and the foreign jurisdiction in respect of items of income that could be subject to tax in both jurisdictions under their respective domestic laws. Tax treaties are intended to operate to relieve taxpayers from double taxation, and usually include a ‘tiebreaker’ test that allocates residence for the purposes of the relevant tax treaty where an entity is a resident of both contracting states to the tax treaty.

Australia has ratified the OECD’s *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument). Where a tax treaty partner has also ratified the Multilateral Instrument then the relevant tax treaty with Australia may then be modified by the terms of the Multilateral Instrument. Australia’s tax treaties with a number of foreign jurisdictions (such as New Zealand and the United Kingdom) have already been modified in this regard, and a significant number are expected to be modified.

Of particular relevance in this context is Article 4 of the Multilateral Instrument, which applies to ‘dual resident entities’. Importantly, Article 4(1) as it modifies Australian treaties provides:

*Where by reason of the provisions of a Covered Tax Agreement a person other than an individual is a resident of more than one Contracting Jurisdiction, the competent authorities of the Contracting Jurisdictions shall endeavour to **determine by mutual agreement** the Contracting Jurisdiction of which such person shall be deemed to be a resident for the purposes of the Covered Tax Agreement, **having regard to its place of effective management**, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall **not be entitled to any relief or exemption from tax** provided by the Covered Tax Agreement...
[Emphasis added]*

Many tax treaties rely upon a company’s ‘place of effective management’ as a means of allocating residency (for the purposes of the relevant tax treaty) where the company is a resident of both contracting states to a tax treaty.³⁵ If a tax treaty has been modified by the Multilateral Instrument, however, then place of effective management is no longer the sole determining

³³ Income Tax Assessment Act 1997 (Cth) sub-division 768-A.

³⁴ Treasury Laws Amendment (2019 Measures No 3) Bill 2019 Schedule 3 Item 113 to be backdated to 17 October 2014 when subdivision 768-A originally took effect. Prior to that date section 23AJ of the Income Tax Assessment Act 1936, which was replaced by subdivision 768-A, was to similar effect as the proposed amendment and the change was made in error, see Explanatory Memorandum to the Bill paragraphs 3.115-3.118.

³⁵ Note that place of effective management is not the same thing as central management and control.

factor. As specified in Article 4(1) of the Multilateral Instrument, place of effective management is a factor that is to be taken into account by ‘competent authorities’, along with place of incorporation and other factors, in arriving at an agreement as to where residency is to be allocated. Further, the adoption of Article 4(1) removes the ability of dual resident taxpayers to self-assess their place of residence for treaty purposes.

The length of time that it could take for the competent authorities to reach agreement in a particular case may be prolonged. In such a case a dual resident company will be denied relief under the relevant tax treaty, and may be subject to double taxation until such time as agreement is reached between the competent authorities and indeed agreement may never be reached as there is no obligation under the new provision to reach agreement.

Companies incorporated in foreign jurisdictions which are parties to tax treaties with Australia that have been modified by Article 4 of the Multilateral Instrument will, therefore, presumably wish to avoid instances of dual residency. The uncertainty now associated with the central management and control test, however, means that a finding of dual residence is more likely to arise.

Capital gains tax

As noted above, if a foreign incorporated company that is wholly-owned by a tax consolidated group becomes an Australian resident under the central management and control test then it will automatically become a member of the consolidated group. Certain capital gains tax events may arise when a company joins a consolidated group,³⁶ which may then give rise to taxable capital gains.

There are also two capital gains tax rules that no longer apply if a foreign incorporated company becomes an Australian resident.

Under the first rule a capital gain that arises from the disposal of shares in a *foreign company* is reduced to the extent that the foreign company is engaged in an ‘active’ business.³⁷ If, therefore, a foreign incorporated subsidiary becomes an Australian resident under the central management and control test then its Australian parent company will no longer be able to access this concession.

Under the second rule a capital gain that arises from the disposal of an asset held by a *foreign company* is only recognised in respect of an asset that is ‘taxable Australian property’, which includes Australian real property and indirect interests in Australian real property.³⁸ A foreign company is not, therefore, liable to Australian tax on capital gains that arise from the disposal of assets that are not taxable Australian property. Again, access to this concession will no longer

³⁶ Including capital gains tax events L3 and L4.

³⁷ Income Tax Assessment Act 1997 (Cth) sub-division 768-G.

³⁸ Income Tax Assessment Act 1997 (Cth) division 855.

be available if a foreign incorporated company becomes an Australian resident under the central management and control test. In such an event, however, the capital gain may still be disregarded provided that the asset in question has been used mainly for the purpose of producing foreign income in carrying on business through a permanent establishment of the subsidiary company.³⁹

Significant global entities

Penalties for the late lodgement of certain prescribed forms by entities that are ‘significant global entities’ are greater than those for entities that are not significant global entities.⁴⁰ These forms include activity statements, income tax returns, fringe benefits tax returns, PAYG annual withholding reports and general purpose financial statements. An entity will be considered to be a significant global entity if it is a member of a group of entities that are part of the same accounting group and the parent entity of the group has an annual global income of at least \$1 billion.⁴¹

The relevant forms to be lodged, however, may depend on the residency status of the company in question. Not all forms required to be lodged by an Australian resident company need to be lodged by a foreign resident company. By way of illustration, a foreign resident company that conducts its operational activity exclusively in a foreign jurisdiction (and hence does not generate Australian source income) would generally not be required to lodge any forms with the ATO. If, however, that company were deemed to be an Australian resident because of a change in the criteria for Australian residency then at the very least it would be required to lodge an income tax return with the ATO in order to report its worldwide income. It may also, depending on the circumstances in question, be required to lodge a general purpose financial statement (if it is a significant global entity) and PAYG annual withholding reports (if payments have been made to foreign residents).

Given the uncertainty now associated with the central management and control test it is conceivable that instances could arise under which the management of a foreign incorporated company is unaware that the residency status of the company has changed from a foreign resident to an Australian resident. The company may then fail to meet its obligation to lodge the relevant approved forms, and hence be liable to late lodgement penalties. Such an unpalatable outcome would then be compounded if the company is a significant global entity, in which case its penalty amount for each failure to lodge will be multiplied by five hundred and result in a penalty that could range from \$105,000 to \$525,000.⁴²

³⁹ Income Tax Assessment Act 1936 (Cth) subsection 23AH(3).

⁴⁰ A ‘form’ in this context is a return, notice, statement or other document that is required to be given to the Commissioner in the ‘approved form’: *Taxation Administration Act 1953* (Cth) Schedule 1 subsection 286-75(1).

⁴¹ Income Tax Assessment Act 1997 (Cth) subsection 960-555(2).

⁴² *Taxation Administration Act 1953* (Cth) Schedule 1 subsection 286-80(4A).

APPENDIX C: RELEVANCE OF INDICIA - EXAMPLES

Comparison of corporate residency outcomes under previous ATO guidance (TR 2004/15), the existing rules (TR 2018/5) and the Board's recommended approach

A number of examples are presented below to illustrate the impact that different factors can have on the question of determining the residency of a foreign incorporated company. In each example, the corporate residency outcome is determined separately by applying the approach under former TR 2004/15, TR 2018/5 and the Board's recommendations. These examples provide guidance on how the Board views the principle of 'sufficient economic connection' would operate in practice, and identifies differences in outcome to current and previous ATO guidance.

Example 1 - fixed capital enterprise

Example 1(a) – Trading and Central Management and Control (CMAC) both in Australia

A foreign incorporated company conducts a 'traditional' mode of business involving significant physical assets (such as manufacturing). Its assets and staff are located in **Australia**.

The directors are always in **Australia** at the time Board meetings are conducted (and attend either in person or via video conferencing facilities).

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Australian resident: carrying on business in Australia and CMAC here	Australian resident: CMAC in Australia	Australian resident: core commercial activities in Australia and CMAC here

In this example, Australia will have worldwide taxing rights over the company under each approach to the central management and control test.

Example 1(b) – mere trading in Australia without CMAC in Australia

A foreign incorporated company conducts a 'traditional' mode of business involving significant physical assets (such as manufacturing). Its assets and staff are located in **Australia**.

The majority of the directors are non-Australian and always in a **foreign jurisdiction** at the time Board meetings are conducted.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident: carrying on business in Australia but CMAC is not here	Foreign resident: CMAC not in Australia)	Foreign resident: core commercial activities in Australia but CMAC is not here

In this example, Australia will not have worldwide taxing rights over the company under any approach to the central management and control test. However, the foreign company has a taxable presence (commonly referred to as a permanent establishment (PE)) in Australia. As such the profits from the core commercial activities undertaken in Australia will be taxed in Australia, as well as certain other types of Australian sourced income (for example, Australian royalties, interest and capital gains on Australian taxable assets).⁴³

Example 1(c) – CMAC in Australia with trading outside Australia

A foreign incorporated company conducts a 'traditional' mode of business involving significant physical assets (such as manufacturing). Its assets and staff are wholly located in a **foreign jurisdiction**.

A majority of the directors are always in **Australia** at the time Board meetings are conducted.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC) ⁴⁴	Australian resident (CMAC in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

⁴³ To avoid unnecessary complexity in the examples, it is assumed that through the combination of domestic law and/or a tax treaty, Australia will tax Australian sourced income derived by the Australian operations of the foreign company.

⁴⁴ Refer TR2004/15 para 6

This example highlights the impact of the revised ATO guidance TR 2018/5, providing a different residency outcome compared to the position up until 2017 and the Board’s recommendation.

Under TR2018/5 the company will now be an Australian tax resident⁴⁵ and prima facie subject to tax in Australia on its worldwide income.

In contrast, under TR2004/15 and the Board’s recommended approach the foreign company will only be subject to Australian tax on certain Australian sourced income.

In practice both scenarios may produce the same Australian taxable position. However, this is dependent on a number of variables, for example, whether Australian tax residency under TR20018/5 caused the foreign company to join an Australian tax consolidated group and whether the company derived other types of income that did not relate to its underlying operating activities and which did not have an Australian source.

Example 1(d) – substantial degree of CMAC exercised in Australia with trading outside Australia

A foreign incorporated company conducts a ‘traditional’ mode of business involving significant physical assets (such as manufacturing). Its assets and staff are located in the **foreign jurisdiction**.

Half of the directors are always in **Australia** at the time Board meetings are conducted, and the other half are always in the **foreign jurisdiction** at the time Board meetings are conducted. Board meetings are held via **video conference facilities**. Each director exercises an equal influence on the decision making of the Board relative to the other directors.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board’s recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC)	Australian resident (substantial degree of CMAC exercised in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

Similar prima facie to example 1(c), this example provides a different residency outcome under the current ATO guidance compared to the position up until 2017 and the Board’s recommendation. However, this example also serves to highlight the potential for greater international tax disputes under TR2018/5.

⁴⁵ Subject to the availability of transitional relief provided in TR2018/5

Typically the foreign jurisdiction where the company is incorporated (and where it undertakes its core commercial activities and half the board is based) would also assert tax residency, necessitating some form of resolution (which is not guaranteed and typically costly and lengthy to achieve) or the company will bear the largely adverse consequences of dual residency.

Example 2 - investment activity

Example 2(a) – CMAC in Australia

A foreign incorporated company engages in investment activity (such as the acquisition and disposal of shares).

A majority of the directors are always in **Australia** at the time Board meetings are conducted. All decisions concerning the company’s investment portfolio are made by the board.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board’s recommended approach
	Australian resident: carrying on business in Australia and CMAC here	Australian resident: CMAC in Australia	Australian resident: core commercial activities in Australia and CMAC here

In this example, Australia will have worldwide taxing rights over the company under each approach to the central management and control test.

Example 2(b) – CMAC in Australia and operating activities managed outside Australia

A foreign incorporated company engages in investment activity (such as the acquisition and disposal of shares).

A majority of the directors are always in **Australia** at the time Board meetings are conducted. Only **strategic decisions** concerning the investment mandate (that is the asset allocation, responsible investment policy and portfolio risk limits) are made by the board. **Operational decisions** concerning the investment portfolio are made and implemented by an **offshore manager**.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC)	Australian resident (CMAC in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

Under TR2018/5 the company becomes an Australian tax resident and prima facie subject to Australian tax on its worldwide income.

Under TR2004/15 and the Board's recommended approach, the foreign company will only be subject to Australian tax to the extent income from its investments have an Australian source (for example certain interest paid by an Australian company).

Example 2(c) – regional headquarters

A foreign incorporated company is set up as the **European regional headquarters** for an Australian outbound investment group with investments across the globe. The company's **staff are based in the foreign country** and focus on matters concerning the **management** of the operating subsidiaries in the European region, and all of these subsidiaries report directly to it. The foreign incorporated company, in turn, **reports to the ultimate parent in Australia**.

The foreign incorporated company develops a pan-regional strategy, and each subsidiary is then responsible for its own local strategy. The main responsibilities of the employees of the foreign incorporated company comprise investment strategy development, valuation strategy, communication and some back office functions (such as marketing, accounting and administration).

The **majority of directors** of the foreign incorporated company are always in **Australia** at the time Board meetings are conducted.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC)	Australian resident (CMAC in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

Similar to example 1(d), this example provides a different residency outcome under the current ATO guidance compared to the position up until 2017 and the Board’s recommendation, and highlights the potential for greater international tax disputes as the foreign jurisdiction where the company is incorporated (and where it undertakes its core commercial activities and part of the board is based) would also be likely to assert tax residency.

Example 2(d) - holding company for internal investments

A foreign incorporated company is a **holding company** for internal investments (such as shares in foreign subsidiaries).

A majority of the directors are always in **Australia** at the time Board meetings are conducted. **Strategic decisions** concerning subsidiaries essentially relate to the payment of dividends, financial reporting requirements and approving the establishment of new subsidiaries and essentially follow group policies and recommendations. The holding company does not employ staff, its decisions are implemented by teams spread across the group in different jurisdictions.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board’s recommended approach
	Australian resident: carrying on business in Australia and CMAC here	Australian resident (CMAC in Australia)	Australian resident: core commercial activities in Australia and CMAC here

In this example, the holding company is an Australian tax resident under each approach. This is on the basis that the factors relevant to determining where it is carrying on its business or where its core commercial activities take place may be similar to those determining where it is exercising central management and control. In these situations the location of central management and control is indicative of where the company carries on business and vice versa’.⁴⁶ As a result the location of directors when attending board meetings may have greater weight in the case of holding companies.

It is noted that in theory both residency and non-residency scenarios may produce the same Australian taxable position as a consequence of participation exemptions included in the tax rules (both for Australian tax residents and under the controlled foreign companies rules). However, this is dependent on a number of variables, for example, whether Australian tax residency under TR2018/5 caused the foreign company to join an Australian tax consolidated group and whether the company derived other types of income, such as interest income.

Example 3 - provision of services

⁴⁶ Re TR2004/15 at para 7

A foreign incorporated company provides services (such as actively managing the operations of other subsidiary companies in the group). All operational activities are performed by employees located in that foreign country.

A majority of the directors are always **in Australia** at the time Board meetings are conducted.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC)	Australian resident (CMAC in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

Similar to example 1(c), this example highlights the impact of the revised ATO guidance post *Bywater*, providing a different residency outcome compared to the position up until 2017 and the Board's recommendation.

Under TR2018/5 the company will now be an Australian tax resident⁴⁷ and prima facie subject to Australian tax on its worldwide income.

In contrast, under TR2004/15 and the Board's recommended approach the company will be considered a foreign resident and therefore only subject to Australian tax to the extent that it also derives certain Australian sourced income.

- **Example 4 – small and medium enterprises**

Example 4(a) – single director based in Australia only performs strategic management

A small corporate group consists of an Australian incorporated holding company and a number of wholly-owned foreign incorporated subsidiaries. Each foreign subsidiary conducts an active business activity in the country of incorporation.

The Australian holding company has a **single director based in Australia**, who also holds all of its share capital. This individual performs the strategic management of the global business whilst operational management is performed by the staff in the country of incorporation. The group does not have sophisticated governance practices, nor is there a formal process of holding board meetings to make key strategic decisions.

⁴⁷ Subject to the availability of transitional relief provided in TR2018/5

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Foreign resident (not carrying on business in Australia and therefore do not need to consider CMAC)*	Australian resident (CMAC in Australia)	Foreign resident (no core commercial activities in Australia and therefore do not need to consider CMAC)

Similar to the outcome in example 1(c), this example highlights the impact of the revised ATO guidance post *Bywater*, providing a different residency outcome compared to the position up until 2017 and the Board's recommendation.

Under TR2018/5 the company becomes an Australian tax resident and prima facie subject to Australian tax on its worldwide income subject to the availability of any carve-outs (for example, those relating to active foreign branch profits or relief for foreign income tax paid on foreign profits included in its Australian assessable income).

In contrast, under TR2004/15 and the Board's recommended approach, the foreign company will only be subject to Australian tax to the extent that it derives certain income from an Australian source (for example Australian interest or royalties).

Example 4(b) – single director based in Australia performs both strategic and operational management

A small corporate group consists of an Australian incorporated holding company and a number of wholly-owned foreign incorporated subsidiaries. Each foreign subsidiary conducts an active business activity in the country of incorporation.

The Australian holding company has a ***single director based in Australia***, who also holds all of its share capital. This individual is also the single director of each of the foreign incorporated companies and performs the strategic management of the global business operations of the group as well as being actively engaged in its operational management (for example, contract negotiation for routine trading transactions, procurement decisions and staffing decisions (of non-key personnel)). The group does not have sophisticated governance practices, nor is there a formal process of holding board meetings to make key strategic decisions.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Australian resident: carrying on business in Australia and CMAC here	Australian resident (CMAC in Australia)	Australian resident: core commercial activities in Australia and CMAC here

In this example, the foreign incorporated companies are likely to be an Australian tax resident under all approaches. This is on the basis the single director is not only undertaking the strategic decisions (that equate to central management and control), but also is undertaking part of the core business activities from Australia. As a result the foreign companies will be prima facie subject to Australian tax on their worldwide income, subject to the availability of any carve-outs (for example, those relating to active foreign branch profits or relief for foreign income tax paid on foreign profits included in its Australian assessable income).

- **Example 5 – CMAC not exercised by directors**

- A foreign incorporated company conducts a property management and investment business **outside Australia**, it holds property in the foreign jurisdiction and employs staff to provide services to the properties within its portfolio.

- A majority of the directors are always in a **foreign jurisdiction** at the time board meetings are conducted. The ultimate beneficial owner of the company, however, **resides in Australia**. Whilst, **all decisions** concerning the company's property portfolio are made at the board level (both strategic and operational), under the company's constitution these decisions are only effective **if the ultimate beneficial owner agrees** with them. All tentative decisions that are made by the directors at the board meetings are therefore forwarded to the ultimate beneficial owner for review and approval.

Corporate residency outcomes	Under TR 2004/15	Under TR 2018/5	Under the Board's recommended approach
	Australian resident: carrying on business in Australia and CMAC here	Australian resident (CMAC in Australia)	Australian resident: core commercial activities in Australia and CMAC here

In this example, the foreign incorporated company is likely to be an Australian tax resident under all approaches. This is on the basis that the ultimate beneficial owner is undertaking part of the core business activities from Australia as well as exercising central management and control. As a result the foreign company will be prima facie subject to Australian tax on its worldwide income, subject to the availability of any carve-outs (for example, those relating to active foreign branch profits or relief for foreign income tax paid on foreign profits included in its Australian assessable income).

APPENDIX D: SUMMARY OF LEGISLATION, CASE LAW AND ADMINISTRATIVE GUIDANCE

Chapter 4 of the Board's September 2019 Consultation Guide is reproduced below. That chapter presented an overview of some of the relevant judicial consideration of the central management and control test, as well as the ATO's administration of the test.

Chapter 4: Context for the review

- It may be helpful, before turning to the ongoing viability of the central management and control test itself, to consider the series of events that have led to the Treasurer's request to undertake a review of corporate tax residency.

1 Board review of 2003

In 2002 the Treasury released a consultation paper titled "Review of International Taxation Arrangements". In that paper, it was noted that applying residency concepts to companies that are part of a multinational corporate group is difficult, and therefore the test for corporate residency "...needs to be pragmatic, balancing factors such as compliance and administrative costs, integrity of the tax system, and the assertion of Australia's taxing rights against other nations' taxing rights."⁴⁸

The consultation paper then expanded on the difficulties associated with the Australian test for corporate residency:

...difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. However, **the case law is not entirely clear**, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this.⁴⁹ [Emphasis added]

Consequently, the Treasurer requested the Board to consider options to clarify the test of

⁴⁸ Commonwealth Treasury, *Review of International Taxation Arrangements: A Consultation Paper Prepared by the Commonwealth Department of the Treasury* (August 2002) 54.

⁴⁹ Commonwealth Treasury, *Review of International Taxation Arrangements: A Consultation Paper Prepared by the Commonwealth Department of the Treasury* (August 2002) 54-55.

company residency so that exercising central management and control alone does not constitute the carrying on of a business.

The Board responded to this request in its “Review of International Tax Arrangements” report of 2003. It agreed with the proposition that the test for corporate residency needs to be clear and practical, and noted that the central management and control test created uncertainty in practice.⁵⁰ It could, according to the Board, lead to “...stage-management of board meetings of companies which operate in a number of countries and have top management distributed among those companies.”⁵¹

A significant difficulty with the central management and control test, according to the Board, involved a complication that was:

...introduced by an **early High Court case** which held that a company which is managed in Australia is likely to carry on business here. This has the potential to make foreign subsidiaries of Australian companies resident in Australia, even though the subsidiaries are incorporated and operate outside Australia. To prevent this possibility, Australian companies may deliberately seek to appoint a majority of directors resident in the country of incorporation of the subsidiary and hold board meetings there. In practice, however, these directors are likely to closely follow the views of the Australian parent company, thus leaving the place of management unclear.⁵² [Emphasis added]

The difficulties enumerated above led the Board to recommend that the central management and control test should be removed from the residency definition in subsection 6(1) of the ITAA1936, and that a company should be regarded as resident in Australia only if it is incorporated in Australia. It does need to be noted, however, that this recommendation was made before the advent of the OECD’s Base Erosion and Profit Shifting (BEPS) agenda to eliminate double non-taxation of income and entities, and consequently this issue needs to be reconsidered within the current and emerging environment.

The “early High Court case” referred to by the Board is *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156 (*‘Malayan Shipping’*).

2 ***Malayan Shipping***

In *Malayan Shipping* Williams J was required to determine whether a company incorporated in Singapore was an Australian resident under the central management and control test. In the course of applying the test Williams J made the following observation:

The purpose of requiring that, in addition to carrying on business in Australia, the central

⁵⁰ Board of Taxation, *International Taxation: A Report to the Treasurer* (February 2003) vol 1, 107.

⁵¹ Board of Taxation, *International Taxation: A Report to the Treasurer* (February 2003) vol 1, 107.

⁵² Board of Taxation, *International Taxation: A Report to the Treasurer* (February 2003) vol 1, 107.

management and control of the business ... must be situated ... in Australia is, in my opinion, to make it clear that the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia. **But if the business of the company carried on in Australia consists of or includes its central management and control**, then the company is carrying on business in Australia and its central management and control is in Australia.⁵³ [Emphasis added]

In *Malayan Shipping* it was conceded that central management and control was located in Australia, but it was argued that the relevant business of the company was not being carried on in Australia. Williams J rejected that submission on the basis that the managing director, an Australian resident, had "...exercised complete management and control over the business operations of the company. It also proves that in these years he exercised an equally complete management and control over the internal administration of the company."⁵⁴

3 Taxation Ruling TR 2004/15

The Board's 2003 report prompted the issuance of *Taxation Ruling TR 2004/15 Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control* ('TR 2004/15') by the Australian Taxation Office ('the ATO'). In that ruling the ATO formally expressed its view that carrying on business in Australia is a separate requirement of the central management and control test, and one that needs to be established independently of the exercise of central management and control in Australia.⁵⁵

In TR 2004/15 the ATO expressed a view that the comments of Williams J in *Malayan Shipping* did not represent a general proposition that the exercise of a company's central management and control in a particular location is sufficient to establish that the company is also carrying on business in that same location. Those comments were, according to the ruling, explicable by reference to the two separate requirements of the central management and control test being met by the same set of facts and activities in that particular case.⁵⁶ Those facts and activities were described in the following terms in TR 2004/15:

The managing director, who resided in Australia, was empowered to appoint and remove the other directors. He had the power of veto of any resolution of the company and had sole authority to affix the seal of the company. The business of the company was the chartering of a tanker from shipping agents and the sub-chartering of the tanker to the managing director, who provided instructions to the shipping agents, gave instructions for signing the charter party and

⁵³ *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156, 159-160.

⁵⁴ *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156, 160.

⁵⁵ *Taxation Ruling TR 2004/15 Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control*, [5].

⁵⁶ *Taxation Ruling TR 2004/15 Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control*, [33]-[34].

prepared and executed the relevant documents.⁵⁷

Malayan Shipping, therefore, represents an instance where, in the words of Williams J quoted above, “...the business of the company carried on in Australia ... **includes** its central management and control”, as opposed to an instance where “...the business of the company carried on in Australia **consists of** ... its central management and control”.

It is, however, arguable that Williams J was of the view that the exercise of central management and control in Australia, by itself, is sufficient to constitute the carrying on of a business in Australia. This is perhaps indicated by Williams’ J observation that “...even if Mr Phillips is right in contending that the sub-charters were of the essence of the trading observations and were made in Singapore, the company was nevertheless a resident within the meaning of the definition.”⁵⁸ Importantly, however, this principle was not decisive in *Malayan shipping* as it was not necessary to apply it given the factual circumstances at hand, and hence it is of limited precedential value.

The ATO adhered to the view in TR 2004/15 until the High Court decision in *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45 (*‘Bywater’*) prompted it to reconsider its stance on this issue.

4 The *Bywater* decision

In *Bywater* the High Court was required to determine whether a number of foreign companies were Australian residents for the purposes of the paragraph (b) definition of resident in subsection 6(1) of the ITAA1936. The directors of these companies resided in foreign jurisdictions, and board meetings were also conducted in foreign jurisdictions. Despite this, it was established at first instance that managerial control and beneficial ownership of each company was solely attributable to an individual who resided in Australia, and that the arrangements in question had been put in place to obscure the location where managerial control was being exercised.

The majority noted that the central management and control test was “...first legislated in 1930, [and] represents a statutory adoption of the test of residence ... formulated ... in *Cesena Sulphur Company v Nicholson*”.⁵⁹ The test has remained unchanged since that time.

The majority then went on to confirm that the test for central management and control has, since its inception, been concerned primarily with identifying the *actual* location of a company’s central management and control, as opposed to mechanically placing central

⁵⁷ Taxation Ruling TR 2004/15 *Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control*, [32].

⁵⁸ *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156, 160.

⁵⁹ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [40].

management and control in the jurisdiction in which a company's board of directors meet. This was expressed by the majority in the following terms:

...there is a **long line of authority** that makes clear that, for the purposes of s 6 of the 1936 Act, a company has its central management and control where the central management and control of the company **actually** abides, that being a question of fact and degree to be determined according to the facts and circumstances of each case.⁶⁰ [Emphasis added]

The location of a board meeting is not, therefore, necessarily conclusive of the location at which central management and control is exercised. However, it also needs to be recognised that in most cases a company's central management and control will be located in the jurisdiction in which its board of directors meet. This was also acknowledged by the majority in *Bywater*:

Ordinarily, the board of directors of a company makes the higher-level decisions which set the policy and determine the direction of operations and transactions of the company. **Ordinarily**, therefore, it will be found that a company is resident where the meetings of its board are conducted.⁶¹ [Emphasis added]

The following caveat was then added:

...it does not follow that the result should be the same where a board of directors abrogates its decision-making power in favour of an outsider and operates as a puppet or cypher, effectively doing no more than noting and implementing decisions made by the outsider as if they were in truth decisions of the board.⁶²

In finding that each company was an Australian resident during the relevant income years the court rejected the presumption that central management and control is located where the directors reside and meet, and furthermore held that:

As a matter of long-established principle, the residence of a company is first and last a question of fact and degree to be answered according to where the central management and control of the company actually abides. As a matter of long-established authority, that is to be determined, not by reference to the constituent documents of the company, but upon a scrutiny of the course of business and trading.⁶³

⁶⁰ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [40].

⁶¹ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [41].

⁶² *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [41].

⁶³ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [77].

This was not a particularly controversial outcome, given the factual circumstances under consideration. It has been noted that the characterisation of the residence test as a question of fact to be answered by reference to a company's *actual* place of management is supported by a long line of authority that extends back to the decision in *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455.⁶⁴

5 Taxation Ruling TR 2018/5 and Practical Compliance Guideline PCG 2018/9

The ATO, in response to the decision in *Bywater*, withdrew TR 2004/15 on 15 March 2017 and replaced it with *Taxation Ruling TR 2018/5 Income tax: central management and control test of residency* ('TR 2018/5'). In this ruling, the ATO expressed its revised view that:

If a company carries on business and has its central management and control in Australia, it will carry on business in Australia within the meaning of the central management and control test of residency.

It is not necessary for any part of the actual trading or investment operations of the business of the company to take place in Australia. **This is because the central management and control of a business is factually part of carrying on that business.** A company carrying on business does so both where its trading and investment activities take place, and where the central management and control of those activities occurs.⁶⁵ [Emphasis added]

It is possible, therefore, under this view that the central management and control test can be satisfied by a foreign incorporated company that carries out operational activities wholly outside Australia.

Practical Compliance Guideline PCG 2018/9 Central management and control test of residency: identifying where a company's central management and control is located was subsequently issued by the ATO in order to provide practical guidance to foreign incorporated companies, in order to assist them with applying the principles set out in TR 2018/5.

This change in the ATO's view appears to be based on two factors.

First, although *Malayan Shipping* is not referred to in the body of the ruling itself, it is referenced in footnote 5 to the ruling as authority for the proposition set out in paragraph 7 of the ruling.

Secondly, in footnote 5 to the ruling the ATO states that this view of *Malayan Shipping* was endorsed in *Bywater*. The ATO's position in this regard is presumably based on an observation made by the court in *Bywater* in respect of a particular contention that was made in *Malayan*

⁶⁴ K Stern & L Coleman, 'Lessons of the Crooked Pantomime: Corporate Residency Following *Bywater* Investments' (2018) 47 AT Rev 231, 237.

⁶⁵ Taxation Ruling TR 2018/5 *Income tax: central management and control test of residency*, [7]-[8].

Shipping. That contention was expressed by the court in the following terms:

It was contended that, although the central management and control of the company was located in Melbourne, upon a proper construction of the definition of “resident” in s 6 of the 1936 Act, a company should not be regarded as resident in Australia, notwithstanding that its central management and control was exercised from Australia, unless the company were also carrying on its business operations in Australia.⁶⁶

The court went on to comment that, “unsurprisingly”, that contention had been rejected in *Malayan Shipping*.⁶⁷ It should also, however, be noted that the court considered *Malayan Shipping* to add “little of relevance” to the matters before it.⁶⁸

Importantly, as with *Malayan Shipping*, the court in *Bywater* was not required to decide whether the exercise of central management and control in Australia is, by itself, sufficient to establish that a business has been carried on in Australia. That was because each company had conducted trading activity in Australia, being the buying and selling of shares listed on the Australian Stock Exchange. It is perhaps arguable, therefore, whether *Malayan shipping* or *Bywater* can necessarily be taken as clear and indisputable authority for the proposition that the exercise of a company’s central management and control in Australia is sufficient, by itself, to establish that a business has been carried on in Australia, even in the event that the operational activity of the company in question takes place exclusively outside Australia.

⁶⁶ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [57].

⁶⁷ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [57].

⁶⁸ *Bywater Investments Ltd v Federal Commissioner of Taxation; Hua Wang Bank Berhad v Federal Commissioner of Taxation* [2016] HCA 45, [57].